5 January 2010

China: Themes and Strategy for 2010

Managing inflation and imbalance

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Strategy

We believe the overall macro environment will remain positive for the equity market in the near term, but macro risks including inflation, policy tightening, a decline in property transactions, and US second dip will likely intensify from Q2 or mid 2010 and investors should be positioned for a possible correction then. Our sector preferences include export, insurance, consumer manufacturing, retailing, real estate in second-tier cities, equipment manufacturing and coal.

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China Macro Strategy

China: Themes and Strategy for 2010

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Economic outlook and structural changes

We expect GDP growth to accelerate slightly to 9.0% in 2010 from 8.4% in 2009. At the components level, we expect a significant increase in the contribution of exports to GDP growth and a major decline in the contribution of investment to GDP growth from 81% in 2009 to 48% in 2010. Consumption, as a whole, should continue its steady growth, but selected sub-sectors will enjoy acceleration.

CPI and asset inflation will likely pose major macro challenges and the resulting policy responses will cause market risks. Structural reforms is likely to focus on addressing economic imbalances by promoting consumption, a low-carbon economy, urbanization and health care.

Equity strategy

Our models suggest average MSCI China index upside potential of ~15% for 2010. Given 2010's unusual macro dynamics, we expect investors to trade the market for outperformance. Under our central scenario, we see upside potential to the indices in the first few months of the year, as the macro environment should remain favorable. However, key risks – deceleration of yoy growth, significant policy tightening and a second dip in the US – should negatively affect market performance from Q2.

Insurance, inflation-leveraged consumer, under-penetrated consumer and equipment manufacturing should offer sustainable upside potential and thus form our core portfolio. For the near term, we are also Overweight on export-related sectors and select materials such as coal. We are Neutral on banks and properties for 2010, but are ready to buy on major dips. We are Underweight on the refining and power sector on policy risks, and dislike telco due to its sluggish demand outlook.

Investment themes

1. **Inflation** -- insurance, consumer and agriculture are leveraged beneficiaries.
2. **Underpenetrated consumer** – health care, packaging, dairy, cosmetics, and online travel are likely to enjoy strong and sustained growth.
3. **Export recovery** – following the recovery of shipping and light manufacturing exports, port machinery and shipbuilding should recover with lags.
4. **Low-carbon economy** – wind and nuclear equipment and energy saving technologies stand out as primary beneficiaries.
5. **Consolidation** – mandatory capacity reduction and consolidation to strengthen market positions of leading materials producers over the medium term.

Our top Buys include Ping An, BoComm, BCIA, Texwinca, New World Dept Store, Vanke, China Merchants, China High Speed, Hengan and Shenhua.

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Top Buys	
Ping An Insurance	2318.HK
Bank of Communications	3328.HK
Beijing Cap Int'l Airport	0694.HK
Texwinca	0321.HK
New World Dept Store	0825.HK
China Vanke	200002.SZ
China Merchants	0144.HK
China High Speed	0658.HK
Hengan Int'l	1044.HK
China Shenhua Energy	1088.HK

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Macroeconomic outlook

- We keep our 2010 GDP growth forecast at 9.0% and expect growth in 2011 to remain largely unchanged. At the components level, the contribution of the export sector to GDP growth should increase, while the contribution of investment is likely to decline steeply from 81% in 2009 to 48% in 2010. We believe the government will slow new project approvals and delay some of the RMB4tr spending to 2011 in order to control FAI growth.
- Uncertainty regarding CPI and asset inflation will pose more significant risks than economic growth volatility in 2010. In particular, food price increases and the potential increase in the velocity of money due to rising inflation expectations could be major challenges to the macro policy and may generate surprises for the market. As for the timing of the policy exit, the official tone of the Central Economic Work Conference suggests no major policy tightening over the next few months, but when CPI inflation reaches 2%, significant policy changes will become possible.
- Another key policy objective for 2010 is to address structural imbalances such as over-reliance on FAI and low-end exports for GDP growth, structural overcapacity, and lack of sustained drivers for consumption growth. Specific reforms that investors should pay attention to include those aimed at promoting consumption growth, a low-carbon economy, health care and urbanization.

Annual GDP growth: less exciting outlook for 2010

We expect GDP growth to accelerate modestly from 8.4% in 2009 to 9% in 2010, and expect the same 9% growth rate for 2011. This forecast implies an exceptionally stable outlook and, compared with the surge in qoq GDP growth in H1 of 2009 and yoy recovery in H2 of 2009, the 2010 trajectory provides less excitement for the equity market – note that equity markets react mainly to changes in growth.

Figure 1: China: annual real GDP growth forecasts

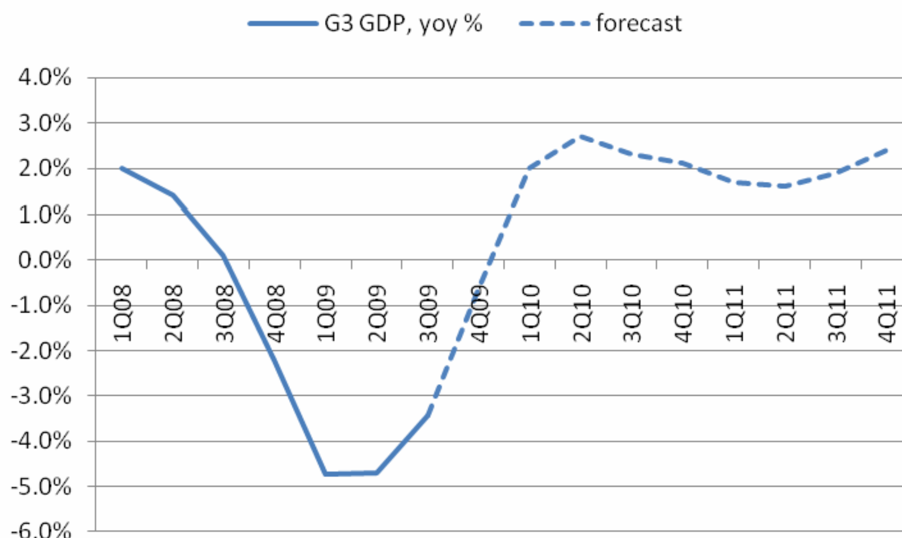
	2008	2009F	2010F	2011F
Real GDP (YoY%)	9.6	8.4	9.0	9.0
Private consumption	10.0	9.3	8.5	9.0
Government consumption	9.9	10.5	9.0	8.5
Gross capital formation	11.2	17.0	9.5	10.6
Exports	12.0	-13.0	13.0	10.5
Imports	15.9	-5.0	14.0	13.0

Source: CEIC and Deutsche Bank forecasts.

For 2010, the two opposing driving forces offset each other: FAI growth is likely to decelerate, but export growth should recover in our view. Consumption represents the steadiest part of the economy, and will likely gain marginally in significance in its contribution to GDP growth.

For 2011, the sources of growth should undergo an interesting reversal. We expect manufacturing overcapacity to be largely absorbed by the end of 2010 with utilization rates returning to the high levels of 2007-08. This should prompt an acceleration of manufacturing/mining FAI growth in 2011. On the negative side, G3 economic growth will likely decelerate from 2.3% in 2010 to 1.9% in 2011 as the benefits of inventory re-stocking and fiscal stimulus fade. This will likely translate into slower Chinese export growth, to about 13% (in USD terms) in 2011, down from 16% in 2010, implying that FAI growth (driven more by the manufacturing sector rather than infrastructure) will enhance its contribution to GDP growth, while the impact of exports will diminish.

Figure 2: G3 GDP growth, yoy %



Source: CEIC and Deutsche Bank forecasts.

Overall, we expect an enhancement to the quality of growth in 2011. Compared with 2009 and 2010, the contributions to growth in 2011 should stem more from corporate sector activities (e.g. manufacturing capex growth) and consumption, and less from the volatile government FAI (dominating growth in 2009) and exports (important for overall growth in 2010).

Quarterly profile of GDP growth: V+U

Figure 3 and Figure 4 show our projections for the quarterly profile of China's GDP growth, on a yoy and qoq (saar) basis respectively. The overall shape of the quarterly profile looks like V+U. On a qoq basis, the next three quarters will likely be the bottom of the "U". The final up-leg of the "U" represents our projection that manufacturing firms will begin to accelerate investment when utilization rates normalize, towards the end of 2010.

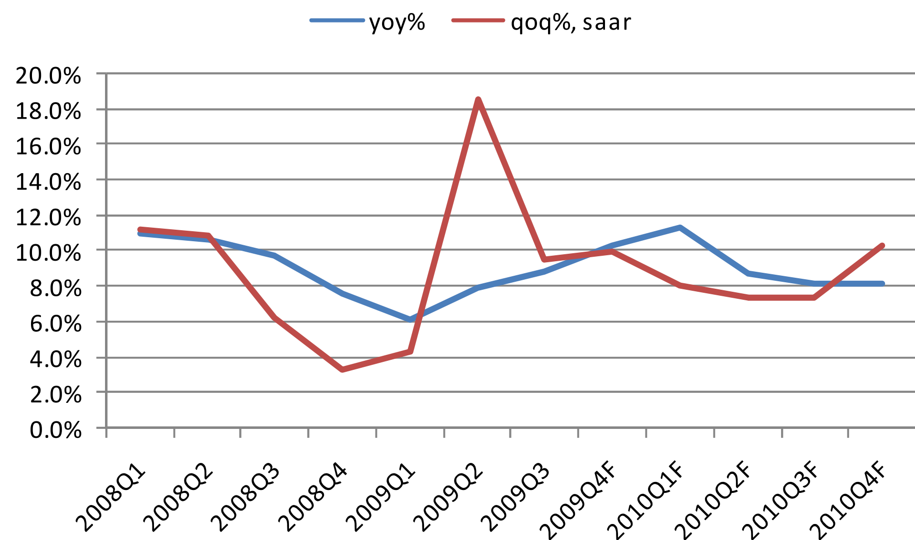
We estimate the yoy GDP growth will likely trend up further to peak in Q1 2010 at over 11%, before decelerating (beginning its second dip) from Q2 2010 towards slightly over 8% in H2 2010. This reflects a likely sharp yoy deceleration in government-sponsored investment from Q2 2010, as well as the diminishing impact of government stimulus for property, auto and white goods consumption in the latter part of 2010.

Figure 3: China: Yoy and qoq (saar) GDP growth forecasts

	yoy%	qoq%, saar
2008Q1E	11.1%	11.3%
2008Q2E	10.7%	10.8%
2008Q3E	9.8%	6.2%
2008Q4E	7.6%	3.3%
2009Q1	6.1%	4.3%
2009Q2	7.9%	18.6%
2009Q3	8.9%	9.4%
2009Q4F	10.3%	10.0%
2010Q1F	11.4%	8.1%
2010Q2F	8.8%	7.4%
2010Q3F	8.2%	7.4%
2010Q4F	8.2%	10.3%

Source: Deutsche Bank, CEIC. Note: the State Statistic Bureau revised up 2008 GDP growth to 9.6% from 9.0% on Dec 26 2009, but did not disclose the revised quarterly yoy GDP growth in 2008. The quarterly yoy growth rates for 2008 are our estimates.

Figure 4: China: Yoy and qoq annualised GDP growth forecasts



Source: Deutsche Bank, CEIC

We see three implications for the future trajectory of qoq GDP growth for the market. First, sequential GDP growth should be in a much narrower range in the coming quarters (e.g. between 7% and 10%), as compared with the past three to four quarters, and thus growth volatility is unlikely to provide as much of an impetus for the equity market. A sharp qoq GDP growth rebound, such as that from 3% in 4Q 2008 to 19% in 2Q 2009, occurs once every few decades, and is highly unlikely to be repeated in 2010. Therefore, we believe market attention will have to shift to other drivers such as inflation, timing and pace of policy tightening, as well as structural changes.

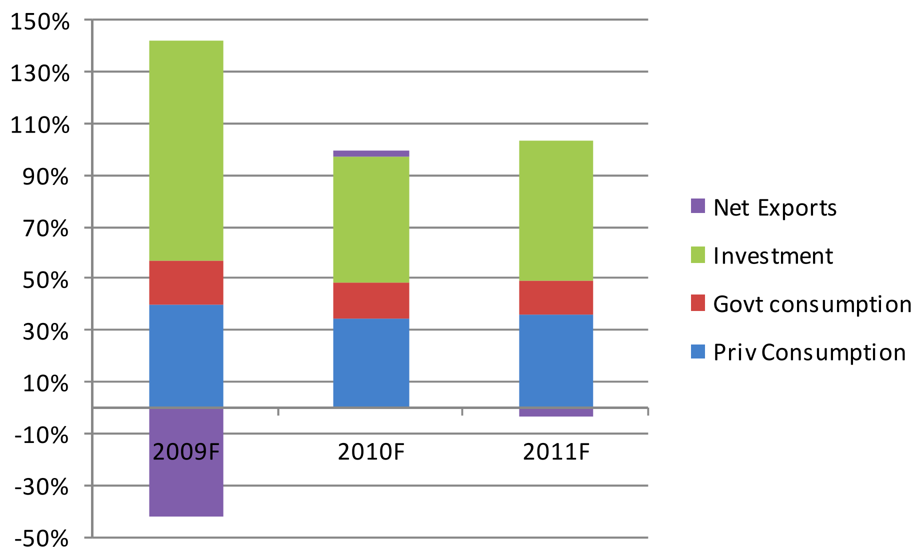
Second, if one overlaps the US sequential GDP recovery with that of China, it is clear that the US recovery is about six months behind China's. China reached its sequential peak in Q2 2009, while US qoq GDP growth just turned positive (2.8%) in Q3, and we estimate it will likely go higher in Q4 (around 4%) and reach its peak in Q1 2010 (around 4.5%). We think that market actions were more driven by China's recovery in H1 2009, and are more driven by US recovery between Q3 2009 and Q1 2010.

Third, we think it will likely take another three quarters for the manufacturing sector to absorb overcapacity. At the current pace of utilization rate recovery, manufacturing utilization rates will rise to the high seen in 2007-08 three quarters later. Then, FAI growth will likely reaccelerate, led by manufacturing/mining sector investments. Given that manufacturing and mining FAIs are bigger than those of government and developers, the reacceleration of manufacturing investments should become the source of a more sustainable GDP recovery, but this will likely take place towards the end of 2010.

Sector outlook: exports and consumption to take over from FAI

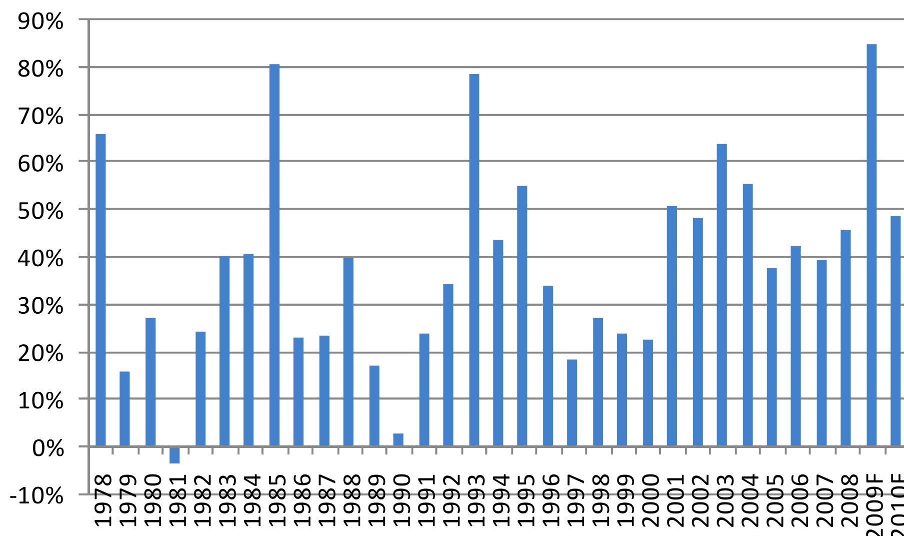
For 2010, we expect the biggest shift in sources of growth will be the rise of contribution from exports and the decline of contribution from FAI. In 2009, the contribution of investment (gross capital formation) to GDP growth was as much as 81% (the highest since such data can be calculated from 1978), with net exports subtracting 39% from GDP growth. In 2010, we expect the contribution of investment to decline to 48%, but the contribution of net exports to rise to a slight positive number.

Figure 5: China: Contribution to GDP growth from consumption, investment and net exports (%)



Source: Deutsche Bank estimates.

Figure 6: Contribution of Gross Capital Formation (GCF) to GDP growth



Source: CEIC, Deutsche Bank estimates

Investment

The key reason why we think FAI growth will likely slow is that the growth of capex on government-sponsored projects is set to decelerate dramatically. We estimate government-sponsored FAI is likely to grow 60% in 2009, and decelerate to around 15% in 2010, as the majority of the RMB4tr stimulus projects had already started in 2009 and central government approvals for new projects and financing (e.g. corporate bond issuance) are slowing. The government is also considering the postponement of some of the RMB4tn spending to 2011.

For a large number of projects that were started in late 2008 and 2009, their capex growth is set to fall to zero. Note that continuation of a project does not typically increase FAI growth; it only maintains the level of growth (i.e. zero growth of FAI). Only when more new projects are started does FAI growth accelerate, and this will clearly not be the case for 2010, given that project starts already peaked in Q2 of 2009. On a yoy basis, the growth rate of RMB amount of new project starts declined to 41% in November 2009 from the peak of 109% in May.

The Central Economic Work Conference, which concluded on December 7 and set the tone for 2010 economic policies, emphasizes that the government should "strictly control new project starts." This is in stark contrast with the message from last year's (2008) Central Economic Work Conference, which called for a "significant increase in public investment."

The background of this significant shift in view on investment is the growing recognition within the central government that the massive FAI growth in 2009 (at 33% during Jan-Nov on a yoy basis) is not sustainable and, in order to contain inflation and overcapacity, some projects that have not yet started should be canceled or delayed. Therefore, the number of new infrastructure project starts in 2010 will likely be significantly lower than in 2009.

We expect manufacturing and mining FAI also to slow modestly in the next two to three quarters to 15-20% as capacity utilization rates remain below the recent highs seen in 2007 and 2008. Based on the past three quarters' experience, we believe it will likely take another three quarters (i.e., by Q4 2010) before high utilization rates can spur another round of acceleration in manufacturing/mining FAI growth. As for real estate FAI, we think it will provide short-term support for overall FAI growth in the coming four to five months, but from mid-2010 it may also become a downside risk as property sales will likely slow due partly to government measures to control speculative demand.

Consumption

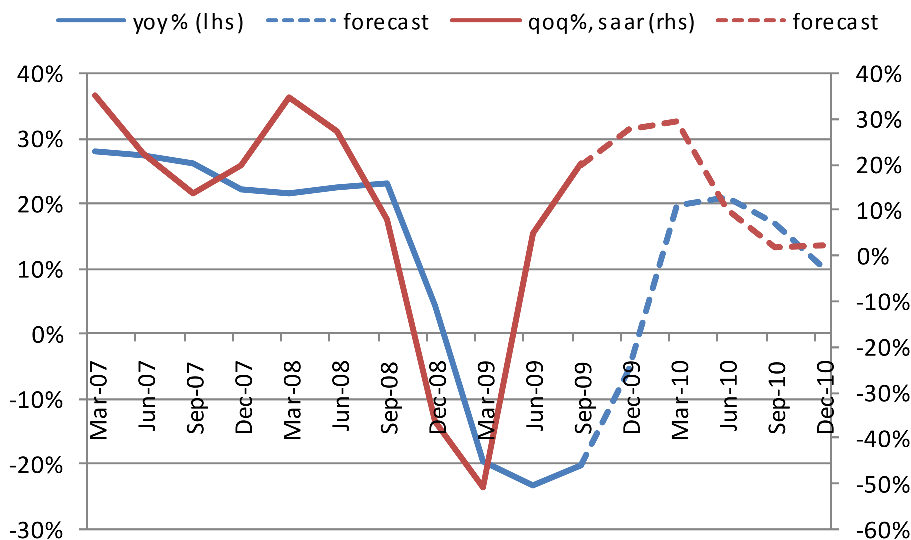
We estimate consumption growth, measured by retail sales growth, will remain steady around 16% for both 2009 and 2010. On the one hand, real retail sales growth may decelerate as government spending (which accounts for about 20% of retail purchases) will slow as fiscal stimulus weakens, the impact of consumption stimulus on yoy sales growth of auto and white goods diminishes, and a likely decline in property sales in 2010 (which would depress demand for white goods and furniture) following the recent surge in speculative demand. On the other hand, as inflation is trending up, we estimate the ASP of retail items will rise by 4ppts in 2010. This should support the overall normal retail sales growth at about the same level as that of 2009.

We believe that those items supported by strong policy stimuli in 2009 (e.g. autos, white goods, and furniture) will experience a deceleration in sales growth in 2010. But other items that have yet to receive material government support (e.g. health care, travel, and new energy products) and under-penetrated consumer items (such as dairy, online traveling and cosmetics) will likely see consumption growth accelerating in 2010.

Exports

On an annual average basis, we estimate China's merchandize export growth will recover to 16% in 2010, up from a decline of 15% in 2009. On a quarterly basis, we expect export growth to recover strongly from the recent -20% yoy in Q3 2009 to a peak of 15-20% in Q2 2010. Export growth will likely slow in the latter part of the year, reflecting the mild second dip of the G3 economy (see Figure 7).

Figure 7: China: export growth forecasts, yoy % and qoq (saar) %

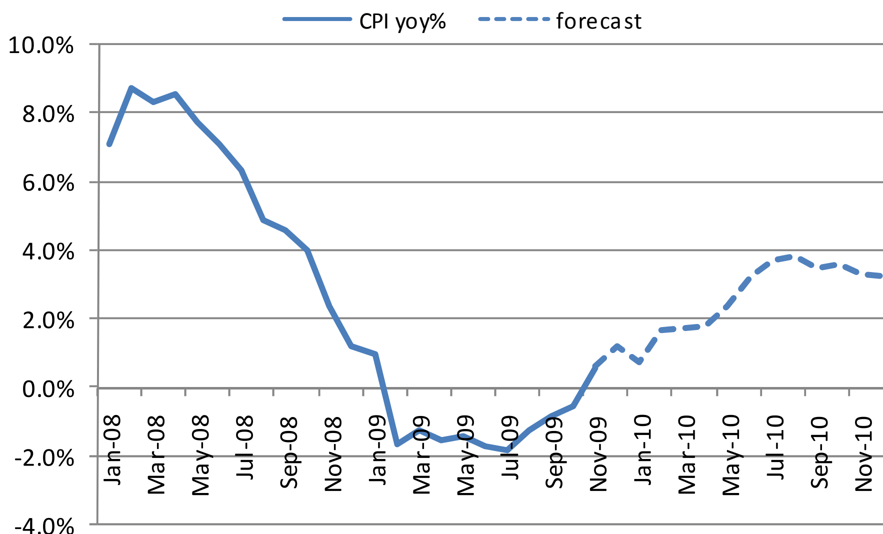


Source: Deutsche Bank, CEIC

Inflation and monetary policy: the biggest uncertainty

Our baseline projection for CPI inflation in 2010 is 3.4%, up from 2009's -0.8%. However, we also believe that there are significant risks to any inflation projection in 2010, much greater than any risks to GDP growth projections. Our estimate shows that 1.5% will be the minimum (given most conservative assumptions) for CPI inflation in 2010, but the actual outcome could be anywhere between 1.5% and 5%, depending on a range of uncontrollable factors. These factors include food prices, oil prices, property prices and, in particular, a change in the velocity of money due to the rise in inflation expectations.

Figure 8: CPI inflation: Our baseline projections

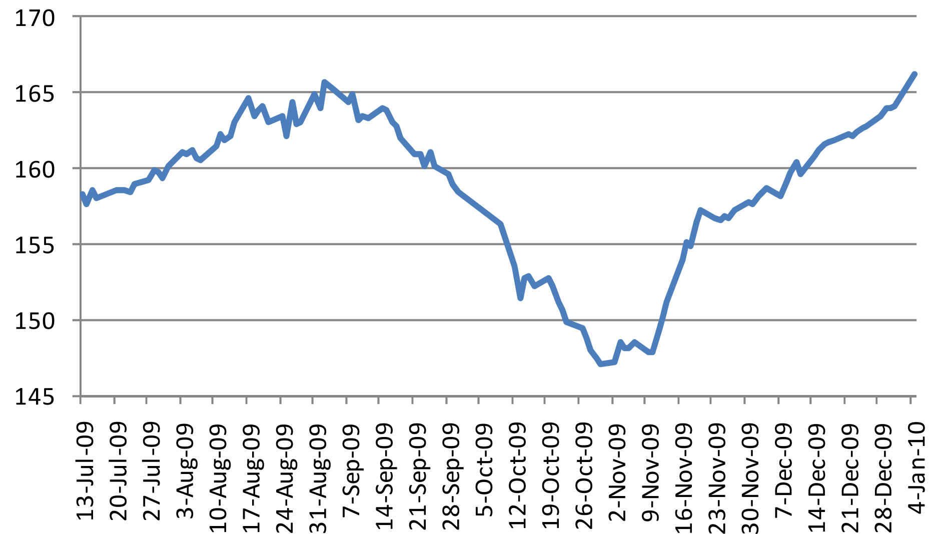


Source: CEIC, Deutsche Bank estimates.

Food price is an obvious near-term concern. Figure 9 shows that the agriculture price index has gone up significantly, by about 10%, in the past few weeks, partly due to the worsening weather conditions in Northern China. Other factors, such as the rapid increase in regional grain prices (e.g. Thai rice price was up 20% in past weeks), decisions of a few Asian

countries to restrict rice exports, and the Chinese government's decision to further increase procurement prices may contribute to the further increase in agriculture prices. Note that food prices account for about 33% of China's CPI basket.

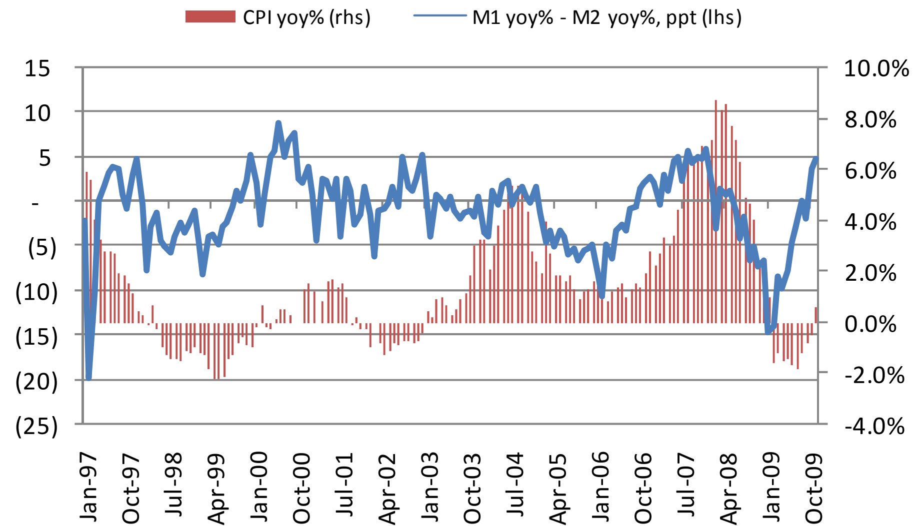
Figure 9: China: daily Agriculture Price Index



Source: Ministry of Agriculture

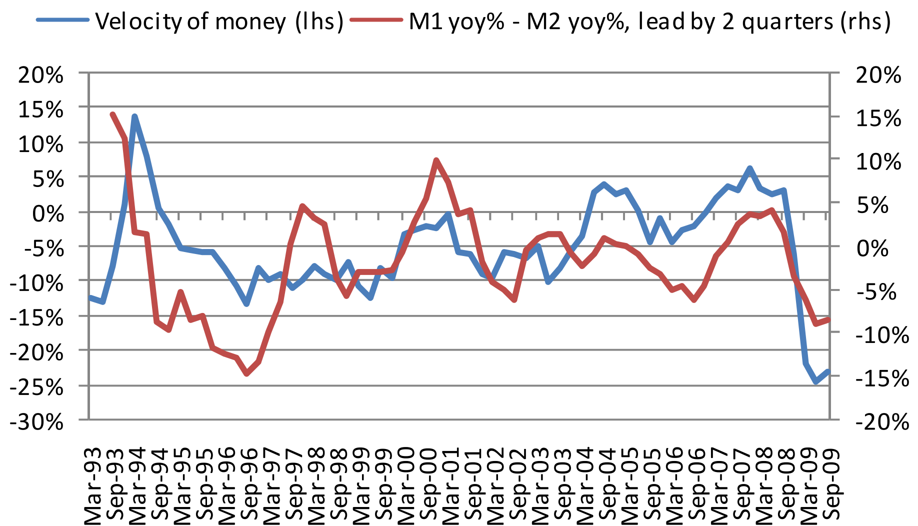
Figure 10 and Figure 11 show that yoy M1 growth has already significantly exceeded M2 growth in recent months. This means that households have begun to move their savings from term deposits to demand deposits, i.e., they are getting ready to spend in light of rising inflation and the forthcoming negative real interest rates. Historically, the differential between M1 growth and M2 growth leads to an acceleration in CPI inflation. In Figure 10 we show that after six months of a rising differential between M1 growth and M2 growth, velocity tends to rise. When the velocity of money – the pace at which money circulates in the economy – rises, this generates inflation even if the money supply does not grow any further. Empirically, it is extremely difficult to pin down the magnitude of the psychological impact of inflation expectations on velocity. Thus, it poses significant risks to the inflation outlook and therefore the monetary policy outlook in 2010.

Figure 10: M1 yoy % – M2 yoy % vs. CPI inflation



Source: Deutsche Bank, Wind EDB

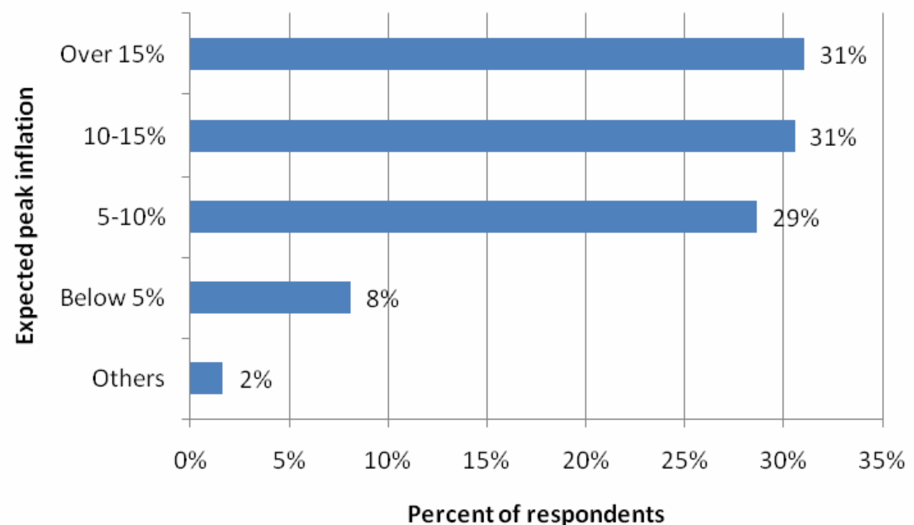
Figure 11: M1 (yoy %) – M2 (yoy %) leads to velocity increase



Source: Deutsche Bank, Wind EDB

A recent survey by Sina.com shows a worrying trend in inflation expectations. While the government and economists generally forecast low single-digit inflation in 2010, 62% of the 31,300 respondents said that they expect inflation to peak at over 10%. Many people complain about the methodology and/or quality of government statistics on inflation, citing, for example, the massive property inflation they see in major cities vs. the very mild property inflation reported by the government. It means that the pace of the rise in inflation expectation will likely be faster than the government data would suggest.

Figure 12: 62% of respondents expect peak inflation to exceed 10%



Source: Sina.com survey as of December 8, 2009

Exit from expansionary policy

Despite the significant uncertainties on the inflation and policy front, economists will need to forecast a baseline scenario. The following is our "most likely" trajectory for policy exit, based on our central scenario of inflation and growth.

1) On monetary policy, we think the M2 growth target will be set at 18% for 2010 vs. the 2009 outturn of about 29%. This implies that the desired level of new lending will be RMB7.5tr vs. about RMB9.6tr in 2009.

As for the use of specific policy instruments, the most likely near-term policy change is for the PBOC to raise the reserve requirement ratio within the next few months. This is mainly driven by the massive increase in FX reserve accumulation, part of which reflects hot money inflows. This requires the use of low-cost instruments such as the RRR (at an annual interest rate of 1.62% vs. the average cost of 2% for PBOC bills) to soak up liquidity.

The use of interest rates as a policy tool remains the most contentious issue. The hawkish views suggest that China should be forward-looking and raise rates before inflation enters its target zone (e.g. before CPI inflation rises to 2%), while the opposition fears that raising rates too early (vs. the US) would induce capital flows. Now that the US is likely to raise rates earlier than expected (e.g. in Q3 2010 rather than Q4, as the US unemployment rate will likely peak in Q4 2009 rather than Q1 2010), we think it likely the PBOC will raise rates from Q2 2010.

We think the RMB should and will resume its gradual appreciation from Q2 2010. The three arguments are: 1) by Q2 2010, we estimate yoy export growth should reach 15-20%, more than enough to eliminate the previous policy concern on unemployment due to the export slump. 2) Emerging market economies will likely join the G3 in complaining about Chinese RMB depreciation against their currencies. Over the past seven months, the RMB has depreciated 10-30% against major emerging market currencies such as the Korean won, Mexican peso, Brazilian real and South African rand. As China is keen to maintain its image as a responsible nation, pressure from these countries is likely to be constructive in influencing China's exchange rate policy. 3) From the first half of 2010, China will begin to feel some imported inflation, especially in oil prices. RMB appreciation can help to offset part of the imported inflation.

2) Prudential banking regulations will become important – if not more important -- policy tools for macro management in 2010, compared with traditional PBOC and NDRC policies. One of the reasons for this is that most project approval rights were decentralized from NDRC (central government) to local levels a few years ago, and politically it is difficult to recentralize power (for fear of being accused of back-peddling on reforms). Therefore, we expect the toughening of CBRC's prudential regulations to play a central role in deterring excessive investments by local governments in 2010. A stricter enforcement of mortgage policies (including the 40% down-payment ratio requirement and reduced interest rate discount) for second home purchases will also contribute to slower growth in lending in 2010.

Regulators have clarified recently that they will require an increase in the capital adequacy ratio for big banks to 11% in 2010. And, as a result, some banks will be under pressure to raise capital from the market. Another policy risk is that the regulators may aggressively enforce dynamic provisioning.

3) On fiscal policy, the budget deficit in 2010 will likely be contained at a similar level to (or only slightly above) that of 2009. This implies that the deficit to GDP ratio – a rough measure of fiscal stimulus -- will fall from 2.9% in 2009 to about 2.8% in 2010. Part of the originally planned central government disbursement under the RMB4tr package for in 2010 (it is about RMB600bn for 2010, compared with RMB500bn for 2009 and RMB100bn for 2008) will likely be delayed to 2011.

Structural reforms

In addition to managing inflation and asset (especially property) bubbles, another key objective of the government's policy agenda will be to address significant structural imbalances. These imbalances include: (1) over-reliance of economic growth on investments and exports, due partly to relatively weaker disposable household income growth and persistently high savings rates; (2) the external imbalance, which manifests itself in a persistently large trade surplus and a rapid rise in FX reserves; (3) overcapacity in a large number of low-end, material and energy intensive manufacturing sectors; (4) and the heavy environmental impact of the current economic growth model. As for specific measures, the government will use a range of policy instruments. Several reforms that would have meaningful market impact are:

1. **Stimulating consumption.** At a recent State Council meeting, it was decided that the policies to subsidize rural electronics sales and the auto trade-in policy will continue. Similar policies to support the demand growth of travel, culture and entertainment activities are likely.

2. **Promoting urbanization.** The hukou (residency) restrictions in small- and medium-sized cities will be relaxed. This measure bodes well for property demand in second- and third-tier cities as it should help accelerate the pace of urbanization over the medium term.

3. **Accelerating health care reform.** This implies that the implementation of the health care reform program has been behind schedule in 2009, and its acceleration in 2010 should benefit companies in the medical equipment and drug distribution sectors.

4. **Promoting new energies.** The government has committed to a 40-45% reduction in carbon emissions per unit of GDP by 2020, and will promulgate more aggressive targets and investment for clean energies such as nuclear, wind, and solar, as well as energy-saving technologies and green cars. Specific policy instruments will include the introduction of resources taxes and even a carbon tax, significant public spending and tax incentives for new energy development, as well as new regulations encouraging the adoption of new energy and energy-saving technologies.

Figure 13: China macroeconomic forecasts

	2008	2009F	2010F	2011F
National Income				
Nominal GDP (USD bn)	4526	4862	5594	6500
Population (mn)	1353	1364	1374	1375
GDP per capita (USD)	3345	3564	4072	4727
Real GDP (YoY%)[1]	9.6	8.4	9.0	9.0
Private consumption	10.0	9.3	8.5	9.0
Government consumption	9.9	10.5	9.0	8.5
Gross capital formation	11.2	17.0	9.5	10.6
Exports	12.0	-13.0	13.0	10.5
Imports	15.9	-5.0	14.0	13.0
Prices, Money and Banking				
CPI (YoY%)	5.9	-0.8	3.4	2.5
Broad money (M2)	17.8	29.0	17.0	16.5
Bank credit (YoY%)	18.8	31.0	18.0	16.0
Fiscal Accounts (% of GDP)				
Budget surplus	-0.4	-2.9	-2.8	-2.0
Government revenue	20.5	19.0	19.3	19.7
Government expenditure	20.9	21.9	22.1	21.7
Primary surplus	0.3	-2.2	-2.1	-1.3
External Accounts (USD bn)				
Merchandise exports	1428.5	1199.9	1391.9	1572.9
Merchandise imports	1133.1	929.1	1142.8	1325.7
Trade balance	295.4	270.8	249.1	247.2
% of GDP	6.4	5.6	4.5	3.8
Current account balance	301.3	260.8	229.1	227.2
% of GDP	7.2	5.4	4.1	3.5
FDI (net)	163.0	70.0	90.0	100.0
FX reserves (USD bn)	1946.0	2400.0	2750.0	3100.0
FX rate (eop) CNY/USD	6.84	6.83	6.63	6.36
Debt Indicators (% of GDP)				
Government debt[2]	20.0	21.3	20.6	20.2
Domestic	19.1	20.5	19.9	19.5
External	0.8	0.8	0.7	0.7
Total external debt	8.3	7.4	6.1	5.1
in USD bn	375.0	360.0	340.0	330.0
Short-term (% of total)	65.0	60.0	50.0	50.0
General (YoY%)				
Fixed asset inv't (nominal)	25.5	32.0	19.0	21.0
Retail sales (nominal)	21.6	15.5	15.5	15.0
Industrial production (real)	12.9	12.0	12.0	12.0
Merch exports (USD nominal)	17.2	-16.0	16.0	13.0
Merch imports (USD nominal)	18.5	-18.0	23.0	16.0
Financial Markets	Current	3M	6M	12M
1-year deposit rate	2.25	2.25	2.79	3.06
10-year yield (%)	3.75	3.80	3.95	4.15
CNY/USD	6.83	6.80	6.75	6.63

Source: CEIC, National Sources, Deutsche Bank Global Markets Research
Note: 1. Growth rates of GDP components may not match overall GDP growth rates due to inconsistency between historical data calculated from expenditure and product method; 2. Including bank recapitalization and AMC bonds issued.

Equity market strategy

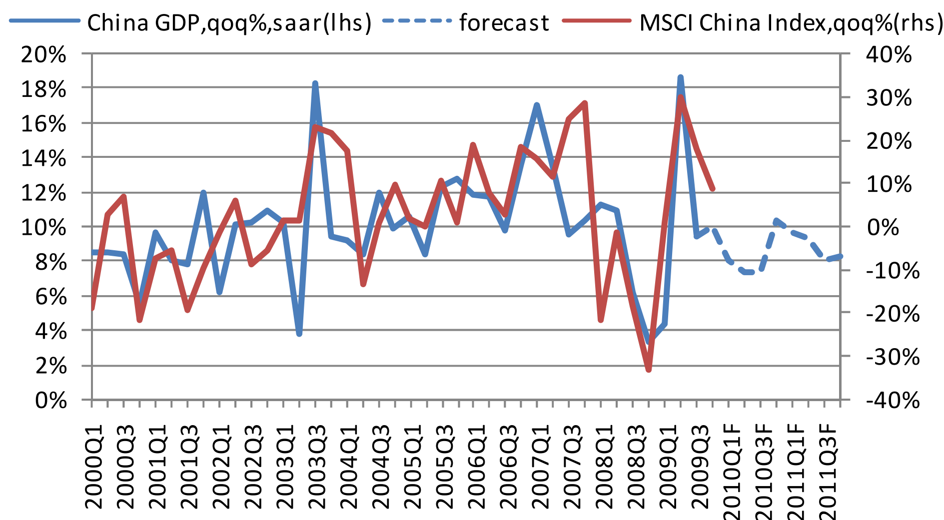
- The prospect of limited upside to growth and a gradual tightening of macro policies in 2010 suggests a less exciting equity index outlook compared with 2009. Our models suggest average MSCI index upside potential of around 15% for 2010.
- Given the unusual dynamics of the macro environment in 2010, we think investors will have to trade the market in order to outperform the index. Under our central scenario, we see upside potential to the indices in the next few months of the year, as the macro environment should remain favorable and many companies are set to benefit from the initial stages of inflation. However, we believe the macro environment from 2Q 2010 will become more challenging. Key risks include a deceleration in yoy economic growth, a further rise in inflation, harsher policy responses to inflation and asset bubbles, a second US dip, and an unwinding of USD carry trades. However, we believe most of these risks will diminish by Q4 2010.
- We expect insurance, inflation-leveraged consumer, under-penetrated consumer, and equipment manufacturing to offer sustainable upside potential in 2010. Companies in these sectors form our core portfolio. For the near term, we stay Overweight on export-related sectors, and we continue to hold raw materials on price uptrend. We are neutral on banks. We believe the risk of a margin squeeze for oil refining and power will intensify in the next one to two quarters. We are Underweight on the telco sector on a sluggish demand growth outlook and the negative earnings impact of 3G capex.

Annual outlook

Limited growth upside suggests a less exciting market outlook in 2010
We expect the macro environment, growth outlook and market valuations to continue to be supportive of China's equity market in 2010, but, compared with 2009, the upside in 2010 is set to be limited due to a much lower potential for further GDP growth acceleration and a gradual tightening of macro policies.

As we pointed out in the economics section, the type of qoq GDP growth recovery seen between Q4 of 2008 and Q2 of 2009 – rallying from 3% to 18% – occurs once every few decades and reflects an unprecedented crisis and massive policy stimuli. We expect 2010's qoq GDP growth to be in a much narrower range – between 7% and 10% – and, on that basis, it will be impossible to drive a market rally like that of the first seven months of 2009 (by 54% for the H share index and 50% for the SHCOMP). Figure 14 shows that historically, MSCI China tends to track qoq GDP growth, and therefore the decline in volatility of qoq GDP growth obviously implies more modest changes in the equity index in 2010.

Figure 14: China: qoq GDP growth vs. MSCI China Index



Source: Deutsche Bank, Bloomberg

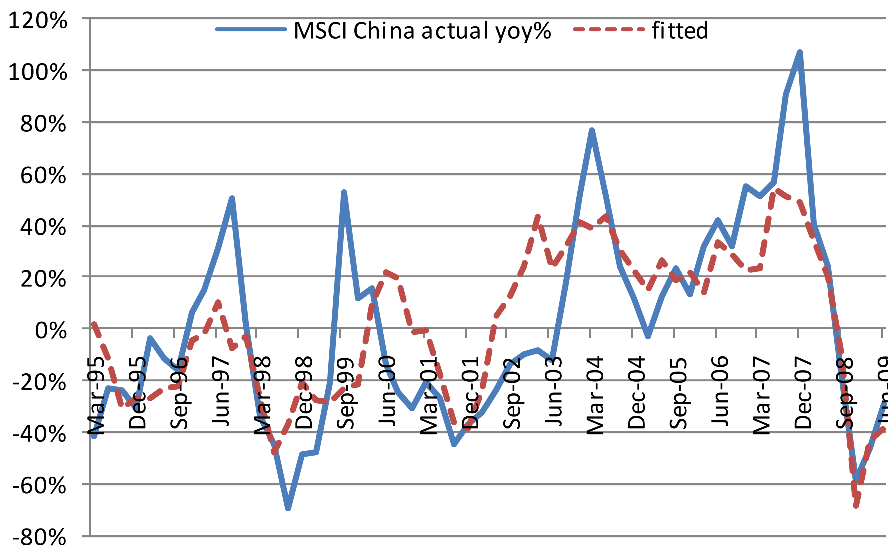
Various models yield an average of 15% upside potential

As no single model can capture all the influences on market performance, we have to compare results from different models. We run models based on macro variables, as well as those based on valuations such as PE, PB, and yield gap. These estimates suggest an average index upside potential of about 15% in 2010 (within a range of 6-20%).

1. Our macro model suggests an index target of MSCI China with 10% upside potential from its current level (as of Dec 31 2009).

Our various regressions on the index on macro variables show that statistically the most significant index movers include export growth (leading by one quarter), IP growth (leading by one quarter) and M1-M2 growth gap (lagging by one quarter). The model fits the actual historical performance with an R-square of 0.57 (see Figure 15). Given our economic forecasts of 16% export growth, 12.5% IP growth and 3% M1-M2 growth spread for 2010, the model predicts 9.6% upside potential for the MSCI China index in 2010.

Figure 15: MSCI China vs. macro model simulation

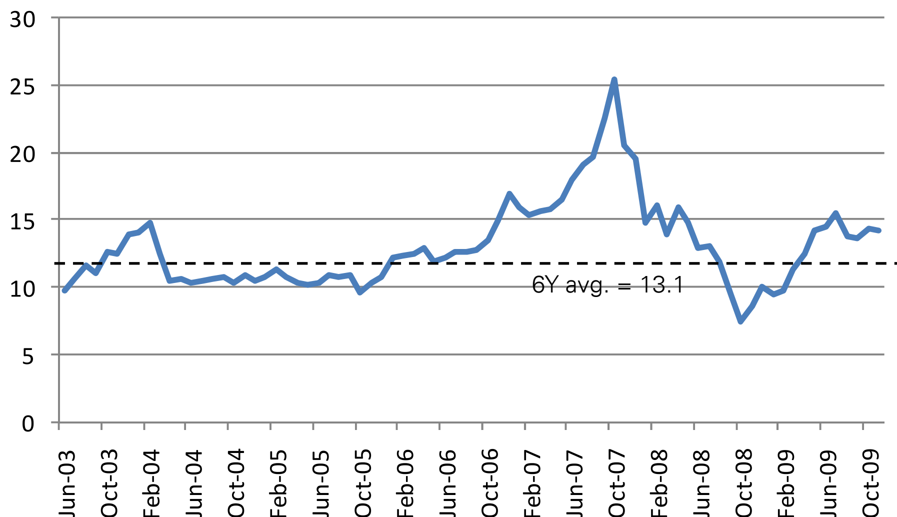


Source: Deutsche Bank, Bloomberg

2. On a PE basis, the MSCI China index is currently trading at 14.3x 2010E PE, which is slightly above the historical average forward PE of 13.1x. Given our EPS growth estimate of 18% for 2011, and assuming the same forward PE is maintained at the end of 2010, the upside potential for the index is about 10%.

On a price-to-book basis, the current ratio (trailing) is the same as the average level since 2006 (the longer PB history is not comparable due to the listing of three major Chinese banks in 2005 and 2006). Assuming by the end of 2010, the same P/B ratio is maintained, it implies 9% upside potential to MSCI China in 2010, given that our estimated index book value will rise 9% within the year.

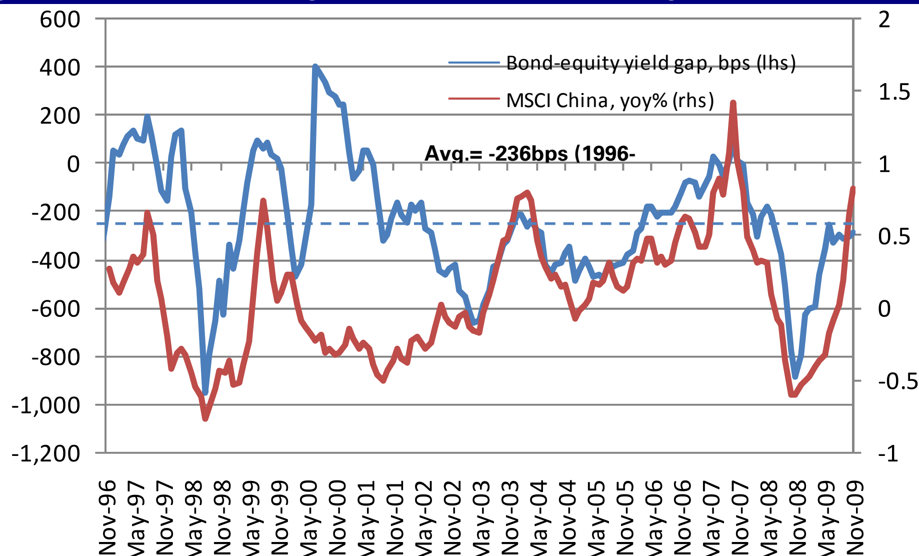
Figure 16: MSCI China 12-month forward PE



Source: Bloomberg

3. Our yield gap analysis suggests that the yoy percentage change in the MSCI China share index has broadly tracked the bond–equity yield gap (see Figure 17) on a long-term basis. Since the current yield gap is still about 20% lower than its long-term average, it implies around 20% upside potential for MSCI China if the yield gap's correlation with index performance remains intact.

Figure 17: Bond–equity yield gap vs. MSCI China yoy % change



Source: Deutsche Bank
Note: Bond-equity yield gap is calculated as US 7-Y treasury yield minus MSCI China price yield (E/P)

4. The index target implied by aggregating Deutsche Bank's bottoms-up target prices suggests 6% (=66/62.4) upside potential.

Three stages in 2010

The market index is unlikely to move in a straight line in 2010. This is because growth will become less of driver for the market, macro policies (both in China and globally) will clearly shift gears somewhere in the middle of the year, and liquidity conditions will change depending on the direction of the USD and the Chinese government's intervention in the assets market. Under our central scenario, we see the market performing differently in three stages, as discussed below:

Stage 1: Positive near-term outlook

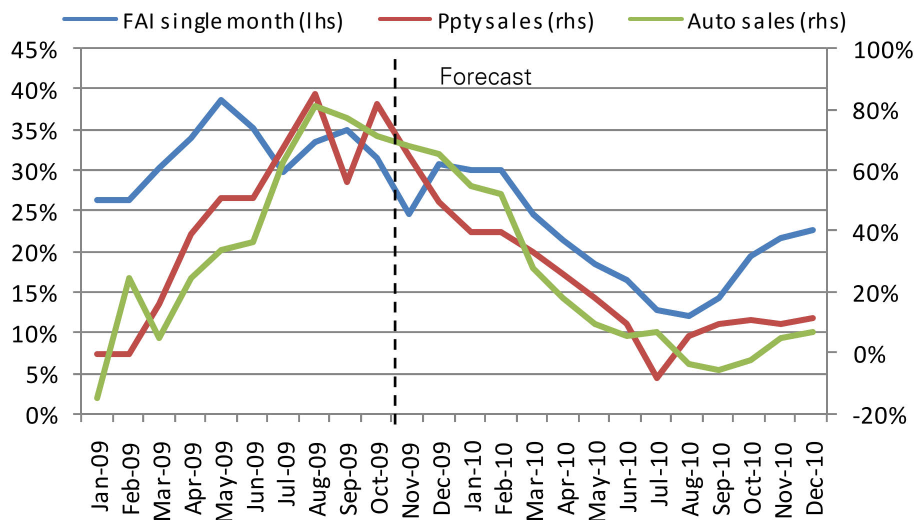
The Central Economic Work Conference kept its official policy tone unchanged, suggesting that drastic tightening measures (e.g. rate hikes) are unlikely before Q2 2010. Liquidity, as measured by the yoy increase in outstanding loans, is set to remain above 25% before March 2010, significantly above the historical average. On the real economy, we expect qoq (sequential) GDP growth to be rather stable in the range of 7%-10% but inflation to rise towards 2% yoy in March. Companies will generally benefit from rising ASP and margin expansion in this environment and earnings upgrades are thus likely to continue. This macro environment should continue to be supportive of equity market performance in the coming few months.

Stage 2: A more challenging macro environment in Q2-Q3

From Q2 onwards, however, several changes in economic, policy and the global environment will likely pose downside risks to the equity market. Specifically, we are concerned about the following four risks:

1) **Growth deceleration.** We believe yoy Q2 GDP growth will begin to decelerate, easily by 2ppts, from the 11.4% rate in Q1. This would be the "official confirmation" of a second dip on the reported yoy growth figures. FAI, property sales and auto sales will also likely begin a deceleration on a yoy basis from Q2 as the impact of stimuli fades and the base effect turns negative.

Figure 18: Decelerating FAI, auto sales and property sales



Source: Deutsche Bank, CEIC

2) **Continued rise in inflation.** We expect CPI inflation to continue to rise in Q2 and Q3 towards the peak of 4% yoy despite the slowdown in yoy GDP growth (see Figure 8). This combination of slower GDP growth with rising inflation would trigger market concerns about "stagflation." We do not think this will persist (i.e., the stagflation fear will last only for two quarters) but it may be sufficient to keep many investors sidelined.

3) **Policies to get harsher.** The reported yoy Q1 GDP growth rate will likely exceed 11%, and March inflation exceed 2%, the psychological threshold beyond which households begin to complain loudly about their money losing purchasing power. Both numbers will be released in mid April. By then, we believe the central bank will be under significant pressure to raise interest rates. Another likely policy reaction is to delay approvals for oil price and power tariff increases. Also, given that property prices will likely continue their uptrend for the next few months, one cannot rule out the possibility that bank regulators and PBOC/SAFE will begin to take specific actions against speculative demand (e.g. by raising second-home mortgage rates, increasing transaction taxes, and re-imposing restrictions on foreigners' property purchases in China).

4) **US second dip.** The external demand outlook may also turn less positive from Q2, as sequential economic growth in G3, especially in the US, is set to begin to decelerate. The market is therefore likely to begin to worry about a second dip in G3, especially if the valuations of global risky asset classes (mainly equities and commodities) become more pricy. This may result in a negative shift in sentiment towards EM equities and may hit export-related sectors particularly hard.

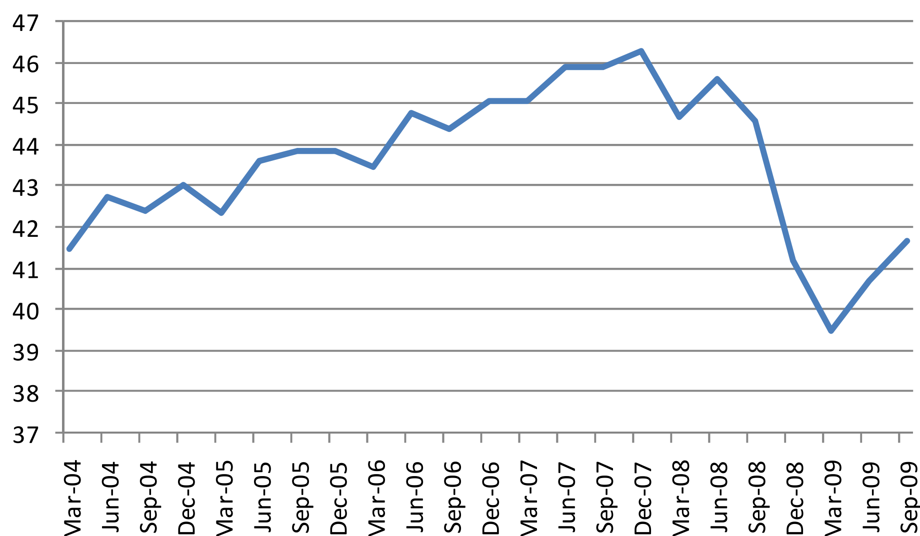
We suggest that investors watch the aforementioned variables very carefully to assess the macro risks from the latter part of Q1 2010.

Stage 3: Diminishing risks toward the end of 2010

We think the above-mentioned difficult period for the market will not last for too long. In our central scenario, by Q4 2010 the inflation risk should diminish but private sector-led economic growth should finally take hold. On inflation, the ongoing de facto monetary tightening (with average monthly lending falling to only RMB300bn in the past few months from RMB1.2tr in H1 2009), the economy will begin to enjoy a disinflationary impact after a lag of about 15 months. That is, CPI inflation will likely begin to drop in Q4 2010. This should eliminate some market concerns on further monetary tightening.

Simultaneously, the manufacturing and mining sectors will likely begin to lead a sustainable recovery in Q4 2010, which may last for a few years. In Figure 19 we show the utilization rate of manufacturing firms in China. According to this data, at the recent pace of recovery, the utilization rate will return to the recent cycle peak seen in 2007-08 by Q4 2010. This should prompt a re-acceleration in manufacturing capex growth. Note that manufacturing and mining FAI is the single largest component of FAI (accounting for 43% of total, vs. 25% for government-sponsored FAI and 23% for real estate FAI).

Figure 19: Diffusion index of manufacturing capacity utilization



Source: CEIC. Data based on PBOC surveys of 5.000 companies.

Given the combination of falling inflation and strengthening corporate sector activities, we think the equity market is likely to react positively to the healthier macro development. By then, not only may China's equity market have resumed its upward momentum, it is also likely to have begun to outperform the rest of Asia again. Note that Taiwan, Korea and Singapore are much more exposed to a second dip in US economic growth than China.

Sector outlook and strategy

In the following paragraphs we summarize our views on the key sectors.

Banks: Neutral

Banks are set to face policy headwinds in the short term, although fundamentally we remain positive on banks' earnings and NPL outlook. We believe that prudential bank regulations will become equally important to – if not more important than – policy instruments for macro management in 2010, compared with traditional PBOC and NDRC policies. One of the reasons is that most project approval rights were decentralized from NDRC (central government) to local levels a few years ago, and politically it is difficult to recentralize power (for fear of being accused of back-peddling on reforms). Therefore, we expect the toughening of CBRC's prudential regulations to play a central role in deterring excessive investment by local governments in 2010.

Regulators have said that the capital adequacy ratio will be increased to 11% in 2010 for large banks and 10% for medium and small banks. As a result, some banks will come under pressure to raise capital from the market. Tracy Yu, Deutsche Bank head of Asia financial research, believes that amount of fund raising will be limited and may eventually be earnings accretive as new shares will be placed at above 1x P/B. However, before any fund raising activities are clarified, many investors will likely stay on the sidelines. Another policy risk is the regulators may more aggressively enforce the dynamic provisioning requirement

Real estate: Neutral

The government will likely continue its policy support for first home buyers and upgrading demand but should also take action to contain speculative demand in major cities. Specifically, the regulators will tighten the implementation of the 40% minimum down-payment ratio and prohibit (or reduce) the interest rate discount for second home mortgages in selected cities. Shanghai has recently raised the deed tax and re-imposed capital gains tax

transactions of investment properties, and other major cities may follow suit. In a later stage, it is possible that the government will re-impose restrictions on foreigners' purchases of properties in major cities.

Historical experience is that in the initial stage of policy changes towards containing speculative demand, property prices tend to rise further, but market sentiment becomes increasingly unstable. As for physical prices in major cities, we will be more concerned about the property price outlook from Q2 2010. A few months following the decline in property sales, which started in the last few weeks of December and early weeks of January, high end property prices may begin to correct. Adding to the risk basket is that the rate hike cycle has probably begun in Q2.

We are not worried about second- and third-tier cities, where property prices are rising at only a modest pace, speculative demand is limited, affordability is reasonable, and urbanization should lead to sustained increases in demand for properties. Overall, we are neutral on the sector with a preference for developers with diversified portfolios and higher exposure to second-tier cities.

Export-related sectors: Overweight

We previously expected the sequential (qoq) export growth to peak in Q4 2009, but, given the recent revision to our US economic forecast, it appears that Chinese exports' sequential peak may be postponed to Q1 2010. Our latest US GDP growth forecast is for qoq growth to have accelerated from 2.8% in Q3 2009 to 4% in Q4 2009 and peak at 4.5% in Q1 2010. The main reason is that inventory restocking will likely start in Q1 2010, along with the first quarterly decline in US unemployment, which should boost consumer spending. Given this outlook, we believe export-related sectors – exporters, container shipping, and ports – should continue to perform positively in the coming few months.

Life insurance: Overweight

On life insurance, we expect the key players to benefit from the acceleration in premium growth, rising fixed income yields (on inflation and rate hikes), and structural reforms including pension and healthcare reforms. Our preferred life insurance name is Ping An, which tends to outperform in a rising interest rate environment.

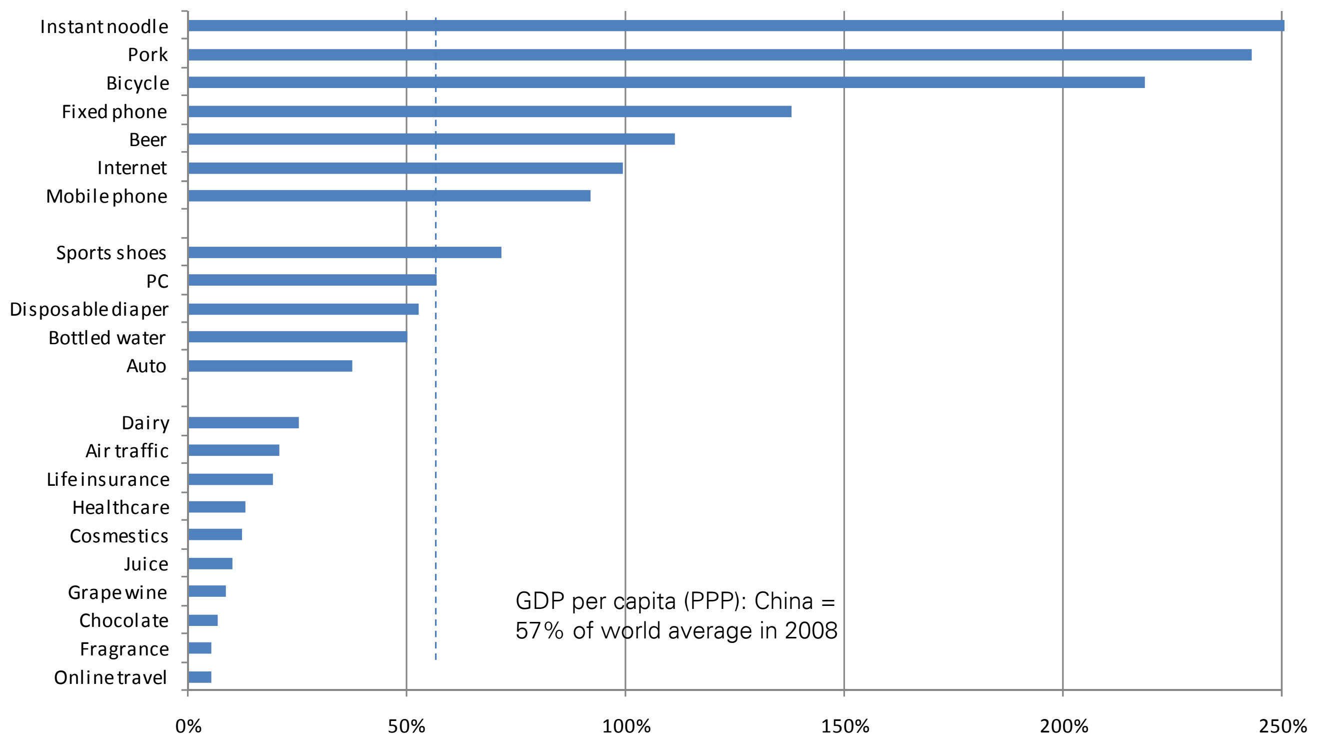
Under-penetrated consumer: Overweight

On consumer, we believe that the government's structural reforms (as discussed in the economics section) will be a positive driver to an improved long-term growth outlook for household income and spending power. In Figure 20, we highlight a range of product and service categories that are significantly under-penetrated in China and, therefore, will likely undergo a sustained period of rapid and even exponential growth. In particular, we like airports, dairy, cosmetics, and online travel. The companies on which our analysts have Buy ratings in these categories include Beijing Capital International Airport, SA SA International and Hengan International.

Inflation-leveraged consumer: Overweight

Over the short and medium term, a rise in inflation would boost the profit margins for retailers and consumer manufacturing at a pace that exceeds market expectations. Historical data suggest that a 4ppt rise in CPI inflation tends to boost earnings growth for retailers by as much as 20-25ppts on high operating leverage. As for consumer manufacturing (e.g. textiles/apparels, non-staple food and beverage, and selected electronics), a 4ppt rise in CPI inflation tends to boost earnings by close to 15-20ppts. Companies in these sectors tend to raise output prices faster than the increase in input prices in an inflationary environment. In these consumer sectors – retailing and consumer manufacturing – that are highly leveraged on inflation, we like Golden Eagle, New World Department Store, Texwinca, Huabao and Hengan.

Figure 20: Penetration rates/per capita consumption in China relative to world average (as % of world average)



Source: Deutsche Bank, all data in 2008 annual consumption unless otherwise noted
GDP per capita: IMF
Instant noodles: Package per capita; World Instant Noodle Association
Pork: Carcass weight kg per capita; USDA
Bicycle: Ownership per capita; http://www.america.gov/bikes.html, National Statistics Bureau of China
Fixed phone: lines per capita; Mobile phone: user per 100 people; Internet: user per 100 people; International Telecommunication Union, Ministry of Industry and Information Technology of China
Beer: Liter per capita; The Brewers of Europe
Sportswear: US$ per capita; Euromonitor 2006
PC: Ownership per capita; International Telecommunication
Disposable paper diaper: Total unit consumption divided by latent demand (3 pieces of diapers per day for each 0-2 year-old baby); China Household Paper Industry Association, Richer Consulting Services, Deutsche Bank estimates
Bottled water: gallon per capita 2007; Beverage Market Corporation
Auto: Ownership per 1000 people; CEIC, Alliance of Automobile Manufacturers
Dairy: Liter per capita; Deutsche Bank estimate based on International Dairy Federation 2006
Air traffic: Passenger carried per 1000 people; Airports Council International, CEIC
Life insurance: US$ premium per capita; SwissRe
Healthcare: US$ expenditure (incl. both government and private) per capita; WHO 2006
Cosmetics: US$ per capita; China Association of Fragrance Flavor and Cosmetic Industries, survey of the Statistic Bureau of Luoyang, Henan Province (the city has similar income level to the national average); Deutsche Bank estimate
Juice: Liter per capita; China Juice Consumption Survey by CTR China (2007), Euromonitor, Deutsche Bank estimate
Grape wine: liter per capita; Tonghua Grape Wine 2007
Chocolate: US$ per capita; Euromonitor
Fragrance: US$ per capita; Euromonitor
Online travel: User per 100 Internet subscribers; iResearch, PhoCusWright, Deutsche Bank estimate

Equipment manufacturing: Overweight

The equipment sector (e.g. telco equipment, medical equipment, alternative energy equipment, railway equipment, and port machinery) will likely continue its strong productivity growth (at over 10% per annum) for many years to come, and should benefit from both import substitution and expansion of their global market shares, in our view. China's aggressive target for reducing carbon emissions should give an extra boost to the manufacturing of wind, nuclear, IGCC equipment and smart power grids.

Telecom: Underweight

With 54% of China's population already being mobile subscribers, demand growth is set to slow in the coming years. In our view, intensifying competition will continue to erode ARPU and a new asymmetric regulatory framework will remain as a policy overhang.

Oil and Gas: Neutral

Deutsche Bank's global commodity analysts are expecting WTI crude oil to average US$65/bbl in 2010, thus leading to our cautious view on CNOOC and PetroChina). On oil refining, the major policy uncertainty will arise from inflation and the resulting possibility of delay in pass-through of cost increases to refined oil prices

Power: Underweight
IPPs will likely have another year of suffering due to the rapid recovery in coal prices, reflecting the government's determination to shut down small coal mines and the transportation bottleneck. The spot-contract coal price spread has expanded from RMB30/ton in 1H09 to the recent RMB110/ton, putting IPPs in a very unfavorable position for the new round of contract coal price negotiation, which will put additional downward pressure on IPPs' margins. In addition, rising interest rates in 2010 will also hurt the IPPs due to their high gearing.

Themes for 2010

In the following chapters, we highlight six investment themes for 2010. All of these themes reflect the impact of either major macro trends or significant structural reforms.

Inflation
We believe sectors that are positively leveraged to inflation include insurance, consumers, and soft commodities. In particular, historical data show surprisingly strong earnings elasticity of consumer manufacturing and retailers to inflation. The clearest "victims" are oil refining and power companies.

The impact of inflation on banks, properties, and construction materials is less straightforward. We conclude that in the early state of inflation, markets tend to react positively to banks and properties. At a later stage, these companies tend to suffer. Construction materials have the highest correlation with property companies in share price performance.

Underpenetrated consumer
We expand the scope of our research on sustainable consumption growth by looking at a much larger number of subsectors. Our methodology is to compare the penetration rate/per capita consumption of different subsectors with the world average.

Our conclusion is that the most under-penetrated sectors – including life insurance, air traffic, cosmetics, online travel, medical equipment, fragrances, and disposable diapers in low tier cities and rural area – should enjoy strong and sustained demand growth in many years to come. The few representative companies in these sectors include Ping An, Beijing Airport, Sa Sa International, Hengan, Ctrip, Mindray, and Huabao.

Export recovery in a flying geese pattern
With China's headline export growth recovering strongly, we believe that the equity market will soon price in most of the growth upside of the first batch of the beneficiaries. However, the performance of various export-related sectors will likely be in a flying-geese pattern. We identify at least three waves of the recovery based on historical correlations and capacity utilization changes. The first wave (from mid-2009 to mid-2010) involves container shipping, ports, trading, and export manufacturing in the textile, electronics, furniture, shoe and toy sectors; the second wave (starting from end-2010) should include port machinery; and the third wave (starting from 2012) will include shipbuilding.

The obvious equity market implication is that investors should, over the coming year or so, gradually switch some of their export holdings towards the beneficiaries in the second and third waves of the recovery, i.e., port machinery makers and shipbuilders.

45% carbon reduction
China has promised to cut carbon emission by 40-45% per GDP unit before 2020. To achieve this aggressive target, it will focus on reducing emissions from coal-fired power plants, as they account for 50% of China's carbon emissions, and significantly increasing the percentage of wind and nuclear in total power production.

We see great potential for wind, nuclear and IGCC (Integrated Gasification Combined Cycle) equipment manufacturing, as key beneficiaries of China's drive to reduce emissions. Smart power grids, as the necessary infrastructure for wider use of alternative energies, should also enjoy rapid demand growth in the coming years.

We are cautious on the outlook for solar power and green cars, as they are far from economically competitive given foreseeable technology progress in the coming years.

Consolidation

A major policy effort in 2010 is to force the reduction in excess capacity and encourage industrial consolidation. We believe this effort is a structural long-term positive for the key players – the consolidators -- in the raw materials sectors such as steel, cement, glass, and coal. The potential consolidators that we like are Angang for steel, CNBM for cement, Xinyi Glass for glass, and Shenhua and China Coal for coal.

Underlying commodity prices as well as the equities themselves have high volatility and some of them (including steel, cement, and glass) also have substantial exposure to property and construction which are subject to policy risks. Therefore, a buy-and-hold strategy is likely to bring substantial short-term volatility to an investor's portfolio. A potentially safer way to play the consolidation theme is to pair trade the Chinese consolidators against some regional peers that are no longer gaining substantial market shares.

RMB appreciation

We expect the RMB to resume its appreciation vs. the USD from March-April of 2010 at an annualized rate of 4-5 per cent. Within the next 10 years, we believe the RMB is likely to appreciate by a cumulative 50%.

We provide our updated estimates of the earnings impact of RMB appreciation on major sectors. The major beneficiaries include airline, steel, paper, auto, and HK/Macau tourism, while losers include oil, nonferrous metals, and exporters.

Our top Buys

We have selected 10 stocks as our top Buys based on our macro and sector views, and analyst recommendations reflecting company-specific fundamentals and catalysts. Our top Buys give investors exposure to insurance, consumer banking, consumer, exports, property demand in second-tier cities, equipment manufacturing and alternative energies. We expect most of them to enjoy sustainable growth, with the exception of exports, which we regard as a short-term recovery story. From a macro perspective, we see upside risks to the earnings estimates for many of these companies as the benefits from inflation, consumption growth in under-penetrated sectors, and productivity growth could well offer positive surprises.

Figure 21: Valuations and earnings forecasts for our top Buys

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	PE 2009	PE 2010	PB 2010	EPS CAGR 09-11	PEG (09-11EPS /2010PE)
Ping An Insurance Grp	2318.HK	Insurance	Buy	68.0	67,024	38.3	26.1	3.5	30%	0.87
Bank of Communications	3328.HK	Banks	Buy	9.0	56,920	14.0	10.3	1.9	29%	0.36
Beijing Cap Int'L Airport	0694.HK	Transportation	Buy	5.1	2,870	70.7	31.5	1.5	106%	0.30
Texwinca Holdings	0321.HK	Textile and apparel	Buy	8.1	1,383	7.8	10.6	2.6	16%	0.65
New World Dept Store Ch	0825.HK	Retailing	Buy	7.1	960	13.6	18.6	2.6	19%	0.98
China Vanke - B Shares	200002.SZ	Real Estate	Buy	9.7	13,158	16.7	14.0	2.2	15%	0.92
China Merchants	0144.HK	Transportation	Buy	25.3	7,890	21.8	18.8	1.9	22%	0.87
China High Speed Trans	0658.HK	Capital Goods	Buy	19.0	3,044	23.5	18.0	3.8	24%	0.75
Hengan Intl.	1044.HK	Household & Person	Buy	57.6	9,056	34.2	27.7	7.9	24%	1.15
China Shenhua Energy	1088.HK	Energy	Buy	38.0	97,458	20.1	16.3	3.3	24%	0.69
Average						26.1	19.2	3.1	31%	0.62
MSCI China						17.1	14.5	2.2	18%	0.81

Source: Deutsche Bank, Bloomberg

Theme #1: Inflation beta plays

- In our view, most of the market uncertainties in 2010 will come from inflation (including real and assets inflation) and the resulting policy swings. We think CPI inflation will be at least 1.5% in 2010, but it could be anywhere between 1.5% and 5.0%. The swing factors include the food, oil, property price dynamics and inflation expectations. On the policy side, the biggest uncertainty lies with rate hikes.
- In this environment, the inflation beta plays (biggest beneficiaries) are insurance, consumers, and soft commodities. In particular, historical data show surprisingly strong earnings elasticity of consumer manufacturing and retailers to inflation.
- The clearest "victims" are oil refining and power companies.
- The impact of inflation on banks, properties, and construction materials is less straightforward. We conclude that in the early stages of inflation, markets tend to react positively to banks and properties. At a later stage, these companies tend to suffer. Construction materials have the highest correlation with property companies in share price performance.

Inflation is a bigger uncertainty than growth volatility

Relative to GDP growth, inflation is a bigger risk in 2010. On GDP growth outlook, most forecasters agree that it will be in a narrow range between 8.5% and 10.0% in 2010. The standard deviation of growth forecasts now is much smaller than it was at the beginning of 2009.

At the same time that growth uncertainty is diminishing, we think uncertainty associated with inflation is rising. Even with the very conservative assumptions (including no changes in manufacturing prices and only 2% rise in food prices for 2001), we estimate CPI inflation will rise to 1.5% in 2010, i.e., the lower bound for inflation. However, a number of uncertain factors can easily boost CPI inflation by a few percentage points. These include:

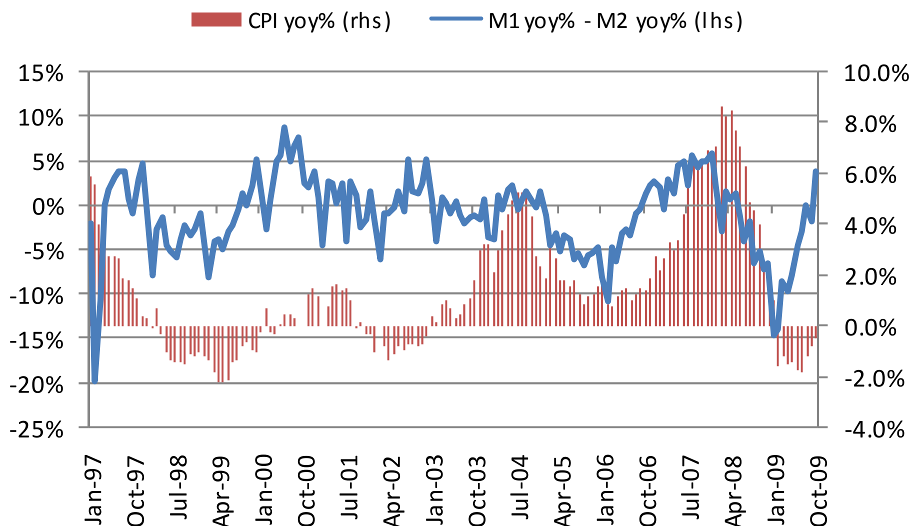
- **Food prices.** A 5% rise in food prices would lead to another 1.6ppt increase in CPI inflation.
- **Oil prices**. A 20% rise in oil prices would lead to another 0.8-1.2ppt increase in CPI inflation (including the direct impact on transport costs and indirect impact on production and fertilizer costs).
- **Property prices.** A 10% in property prices would translate into approximately a 0.5ppt rise in CPI. About 5% of the CPI basket is imputed rental. Historically, property prices transmit to imputed rentals with a lag of about four months. In addition, retailers eventually pass through most of their rental cost increases to selling prices of products and services. While it remains very hard to quantify the aggregate CPI impact due to lack of quality historical data, our rough estimate suggests that a 10% rise in property prices should eventually lead to 0.5-1ppt increase in overall CPI.

Under the above three assumptions -- none of which seem outrageous -- CPI inflation could see an additional increase of 3.5ppts to reach 5% (up from the lower limit of 1.5%). This means that CPI inflation could be anywhere between 1.5% and 5% in 2010.

Another significant – and growing -- uncertainty is consumer behavior driven by inflation expectations. In Figure 22, we show that typically two to three quarters after M1 growth exceeds M2 growth (which has occurred since July 2009), the velocity of money – the pace at quick money circulates in the economy – tends to rise. This is because when inflation expectations intensify – i.e., more people believe that inflation will grow faster than interest

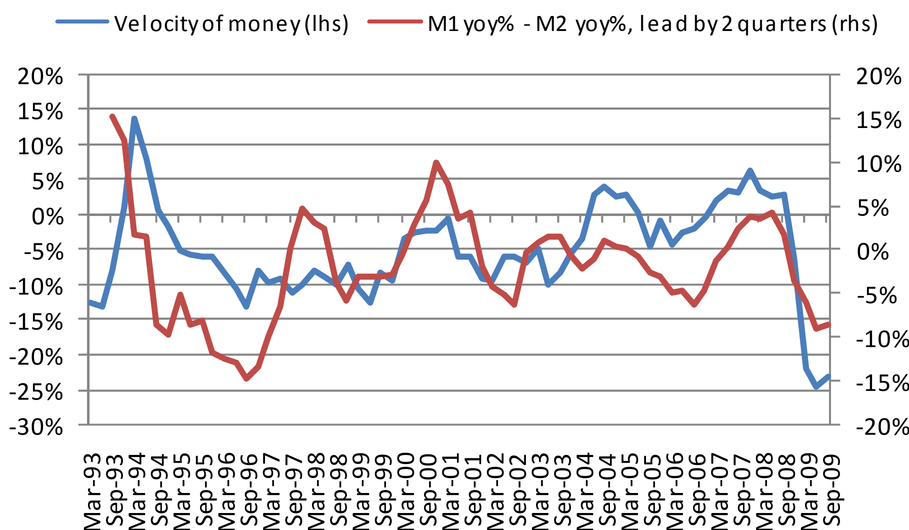
rates – they tend to take money out of the banks and spend at a faster pace. This increase in velocity will drive up inflation even if money supply remains constant. But exactly by how much the velocity will rise is virtually impossible to forecast.

Figure 22: M1 (yoy%)-M2 (yoy%) vs. CPI inflation



Source: Deutsche Bank, CEIC

Figure 23: M1 (yoy %) – M2 (yoy %) leads to velocity increase



Source: Deutsche Bank, Wind EDB;
Note: the velocity of money is defined as the differential between nominal GDP growth and M2 growth

The market implication is that with a very uncertain inflation outlook, macro policies are also likely to be sources of surprise. If CPI is 200 bps higher than market expectations, interest rates will probably be raised three to four times more than consensus forecasts. Uncertainties mean surprises and thus market impact. We believe that for 2010 a large part of the market swings (at least short-term swings) will come from surprises due to changes in outlook for inflation, asset bubbles, and the resulting policy shifts.

We outlined a likely roadmap for macroeconomic policy changes in 2010 in Section I (economics section, page 10), but one should note that all these projections are based on our central scenario for growth and inflation. In the event CPI and asset inflation perform very differently from our baseline, this could substantially alter the outlook (timing and magnitude) for interest rates, banking regulations (e.g. the enforcement of bank capital requirements and dynamic provisioning), as well as policies for the real estate market.

In the following sections, we discuss the market impact of this macro environment of rising by uncertain inflation. We conclude that the sectors that are most positively influenced include insurance, consumer, and soft commodities. The clearest "victims" are oil refining and power companies. However, the impact on banks, properties, and construction materials is less straightforward. These stocks are very sensitive to the small changes in macro outlook and timing of policy responses.

High-beta winners: insurance, consumer, and agriculture

In an environment of rising inflation but with uncertain pace and magnitude, the obvious winners include insurance, consumer, and soft commodities. In particular, we found that the earnings elasticity of consumer manufacturing and retailers to inflation is significantly higher than generally perceived.

Insurance

Insurance companies are poised to benefit from higher bond yields, as new funds are invested in bonds at higher yields. In addition, higher interest rates would push up negotiated time deposit rates. These benefits are more than offsetting the near-term mark-to-market losses on bond portfolios. According to calculations by Deutsche Bank's insurance sector analysts Bob Leung and Jones Ku, every 50bp rise in the investment yield leads to an 8% increase in EV for China Life and a 7.5% increase for Ping An.

Consumer

On consumer, the rise in CPI typically implies an increase in ASP and profit margins. In Figure 24, based on data from listed A share companies since 1990, we show that the profit margin of the consumer manufacturing sector (including electronics, textile, apparel, furniture, food, beverage, leather, and tobacco) is positively correlated with CPI inflation. For each 1ppt increase of CPI, the net margin of the consumer manufacturing sector increases by 0.21ppt. One plausible explanation is that in an inflationary environment, consumer manufacturing companies tend to find it easier to raise selling prices at a pace faster than (but using the excuses of) input price increases.

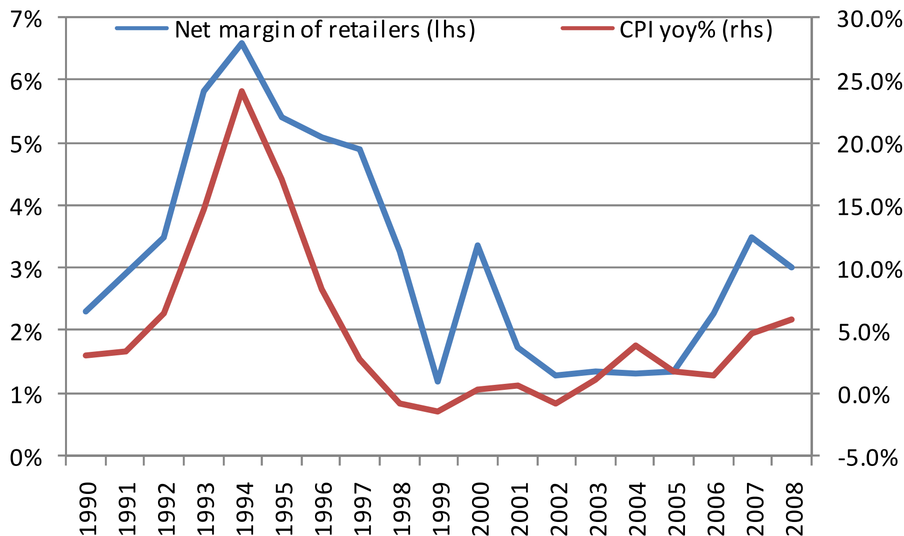
Figure 24: Net margin of consumer manufacturing vs. CPI

Source: Wind, Deutsche Bank

Another segment of the consumer sector is retailing. Based on data from listed A share department stores, supermarkets and other retailers, the correction between the net margin of retailers and CPI inflation is also highly positive (see Figure 25). For each 1ppt increase in

CPI inflation, the net margin of retailers tends to increase by 0.44ppt. The business logic is that consumer retailing has high operating leverage. For those who own their premises, this cost is fixed. For those who rent their premises, rental agreements tend to change only every one to three years.

Figure 25: Net margin of retailers vs. CPI



Source: Wind, Deutsche Bank

If these historical correlations remain valid, and given our forecast that 2010 CPI inflation will be 4 ppts higher than that of 2009, then it implies that consumer manufacturing companies will see their EPS growth accelerating by 15-20ppts and retailers should accelerate 20-25ppts in 2010. These growth rates are significantly higher than consensus analyst forecasts, which generally predict only a slight acceleration (by single digit percentage points) in earnings in 2010 for the consumer sector[1].

Figure 26: Impact on net margin of consumer sector of 4ppt rise in CPI inflation

	Impact on net margin for 4ppt CPI surprise	Jan-Sep 2009 net profit margin	Historical average net profit margin	Margin sensitivity for 1ppt CPI change	# of stocks
Consumer total	22%	6.8%	4.6%	0.38	203
Manufacturing	18%	9.9%	6.2%	0.44	148
Light Ind Divers	44%	6.7%	5.7%	0.74	38
F&B	15%	12.2%	7.1%	0.47	48
Textile	13%	7.3%	4.9%	0.24	62
Retailing	24%	3.4%	2.7%	0.21	55
Dept store	23%	3.7%	2.7%	0.21	49
Supermarket	31%	2.4%	2.7%	0.19	6

Source: Wind, Deutsche Bank, Note: Light Industry Divers include companies in the sectors of printing, home furnishing, packaging, cultural products, etc.
Note: the net margin of department stores are calculated based on gross sales proceeds

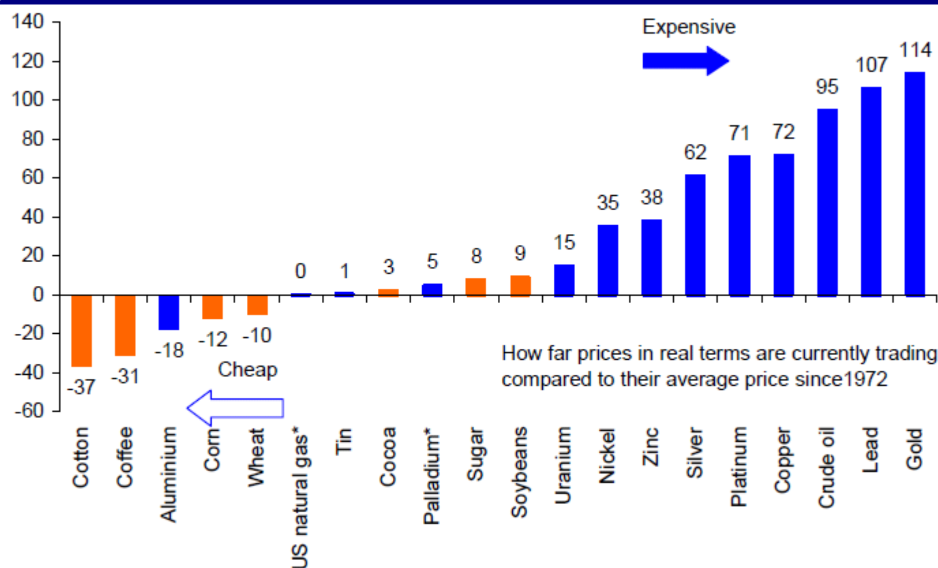
[1] According to Wind consensus, analysts forecast net profit margin of the 203 consumer company (Figure 26)to be virtually flat in 09F (6.5%) and 10F(6.9%).

Soft commodities

Over the past 50 years, all the six inflation episodes (with annual peak CPI exceeding 5%) involved significantly higher food inflation. In fact, food prices on average rose at a pace doubling CPI inflation during these periods. In other words, the beta of soft commodities is two on CPI inflation. In this round of inflation, it appears very likely that soft commodities will again be a major contributor, given the rising trend of animal feed and edible oil prices. Deutsche Bank's global commodities team is also bullish on soft commodities, for the following specific reasons:

- We expect the US Environment Protection Agency to increase the permissible blend of ethanol in gasoline from 10% to 15% from the middle of 2010. It will add an additional 7 million gallons to ethanol demand and sustain strong demand side fundamentals for corn (over 30% of US corn harvest is used for ethanol production). As a result, animal feed prices are likely to rise further.
- The El Nino weather pattern threatens to disrupt grain production and potentially lead to agricultural shortages, most notably across Asia.
- According to the USDA, inventories in a number of agricultural markets are low and set to fall further heading into 2010. For example, global corn inventories are now equivalent to just 60 days of consumption, versus an average of 88 days between 1960 and 2008.
- From the valuation perspective, grain prices are trading at a sizeable discount to their long-run historical average in real terms.
- In the short term, China's weather conditions appear to be worsening again in the winter and will likely disrupt agriculture supply and transportation and push up prices of meat and vegetables.

Figure 27: Value of commodities in real terms



Source: Deutsche Bank, Bloomberg (end November 2009), quotes from Deutsche Bank Global Commodities Weekly, 11 Dec 2009 issue

Obvious losers: oil refining and power

When CPI rises to 4%, a typical government reaction is to delay the adjustments of administered prices such as power tariffs, refined oil prices, and water tariffs. Such price interventions were implemented in 1994, 2004, and early 2008. We are not suggesting that price controls will be inevitable in the coming few quarters, as our projected CPI inflation of 4% by mid 2010 will be on the margin of the government tolerance level. However, the market may at least begin to price in some probability of price control by then, and therefore share prices in these sectors will likely suffer.

In addition to the risk of the government not allowing the pass-through of the on-going rise in coal prices, IPPs universally have high gearing. Other than airlines (which have mainly borrowed external debt), power is the most leveraged sector. The FY09 average net debt/equity ratio is 219% for the five listed major power groups. Deutsche Bank power analyst Michael Tong's sensitivity analysis shows that 81bps of rate hikes in 2010 would lead to a 5-10% decline in earnings.

For oil refiners, the new oil pricing system introduced by NDRC at the beginning of 2009 implies margin squeezes when crude prices exceed USD80bn. But even if the crude price is below USD80/bbl, the margin is not necessarily safe. The official rule says that when the crude oil price is below USD80/bbl, a full pass-through will be allowed; when the crude oil price is between USD80/bbl and USD140/bbl, pass-through will be only partial (i.e., margin squeeze will ensue); and when the crude oil price is over USD140/bbl, no refined oil price adjustments will be permitted (i.e., refiners will run at a loss). The reality is that the previously announced formulas have never been strictly adhered to, i.e., the tendency for the regulators to renege on the formulas is strong when CPI rises to sensitive levels. Recently, in light of the rising CPI trend, the NDRC said that "the government should avoid overly frequent price adjustments in an uncertain economic environment."

Trading stocks: banks, properties, and materials

The implications of the inflation and resulting policy changes are much less straightforward for banks, property and construction materials. In the following paragraphs, we argue that the performances of these sectors critically depend on the timing and aggressiveness of specific policy actions, and historical experience does not offer much guidance.

Banks

We think banks will face several policy uncertainties in the coming months:

First, in 2010 prudential bank regulations will become equally important to – if not more important than – policy instruments for macro management, compared with traditional PBOC and NDRC policies. One of the reasons is that most project approval rights were decentralized from NDRC (central government) to local levels a few years ago, and politically it is difficult to recentralize the power (for fear of being accused of back-peddling on reforms). Therefore a toughening of prudential regulations will have to play a central role in deterring excessive investments by local governments in 2010. Another reason is that globally the G2 will likely agree on a new framework for prudential regulations involving higher CAR ratios, and this would also give another impetus for CBRC to tighten.

Regulators will have to raise the capital adequacy ratio for major banks to 11% and, as result, banks will be under pressure to raise capital from the market. Although the amount of fund raising will likely be limited (to less than 5% of the existing capital base according to our banking analyst Tracy Yu) and may eventually be earnings accretive as new shares will be placed at above 1x P/B, uncertainties arising from the timing and magnitude of specific fund raising plans will likely cap share price performance until they are clarified. Another policy risk is that the implementation of dynamic provisioning will likely negatively impact banks' earnings growth in 2010.

Second, in the first few months of 2010 banks may again front-load their 2010 lending, in order to capture the full-year benefit of interest income. Based on the normal seasonality (65% in H1 and 35% in H2) and our expectation of annual total new lending of RMB7.5tn, the monthly average net lending in H1 should be around RMB800bn. Should the front-loading result in more than RMB1tn monthly lending in the first three quarters of 2010, the regulators will have no choice but to resort to more aggressive action including high-profile window guidance, penalties for banks via targeted bill issuance, and RRR hikes, and this would further strengthen the case for increases in benchmark rates.

We think in the coming three to four months, these policy uncertainties will continue to be an overhang and many investors are likely to remain on the sidelines. Once these uncertainties are clarified, and with positive fundamentals, the large banks are likely to outperform the broader market again.

Property

The State Council stated that the government would continue its policy support for first home buyers and upgrading demand but will take takes action to contain speculative demand in major cities. Specifically, we think regulators will more aggressively implement the 40% minimum down-payment ratio and prohibit (or reduce) the interest rate discount for second home mortgages in selected cities. Tax policies will also become less favorable for speculative purchases in 2010. At a later stage, it is possible that the government will re-impose restrictions on foreigners' purchases of properties in major cities.

Historical experience is that in the initial stage of policy changes towards containing speculative demand, property prices tend to rise further, but market sentiment becomes increasingly unstable. As for physical prices in major cities, we will be more concerned about the property market outlook from Q2 2010 when exports should have fully recovered (and therefore the government will feel less constrained in dealing with property inflation), overall inflation has risen above 2%, and the rate hike cycle probably has begun.

It appears to us that the growing policy uncertainty and possible physical price corrections in a few major cities will likely cap the performance of property stocks for a while. However, after some stabilization of property prices, expectation that the government will relax policies will probably trigger another rally in property share prices later in the year.

Fundamentally, we are not worried about second- and third-tier cities, where property prices are rising only at a modest pace, speculative demand is limited, affordability is reasonable, and urbanization will lead to sustained increases in demand for properties. Therefore, in the event of significant market corrections, we would suggest investors buy developers with diversified portfolios and major exposure to second-tier cities.

Construction materials

There are many variables affecting the performance of construction materials such as steel and cement. On the demand side, government-funded investment should decelerate, but property investment growth may continue for a while before slowing from the middle of 2010. On the supply side, the government's efforts to scrap old and inefficient capacity and limit new investment should help support profit margins, if the policy is effectively implemented. In addition, consolidation may help large players to expand at low cost and gain market share. However, the complexity of these factors, the uncertain effectiveness of government policies, and the significant short-term inventory swings make it very difficult to predict the market outlook.

Another way that can help predict the share price performance of construction materials is to look at their correlation with other sectors. We found that, historically, the share price performance of construction materials has had almost perfect correlation (95%) with property stocks since the Lehman collapse. On the other hand, its correlation with construction services stocks (mainly infrastructure construction) is a much lower 70%. This simply suggests that most factors that drive the performance of property stocks (including property policies, interest rates, and property market inventory) also tend to affect construction materials in the same way.

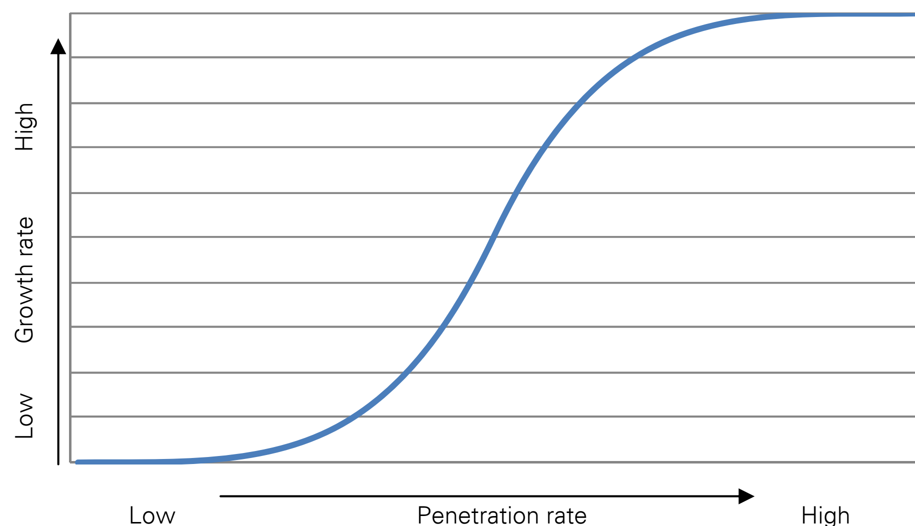
Theme #2: Underpenetrated consumer sectors

- In our report *From Cyclicality to Sustainability* published on 19 October 2009, we argued that investors should gradually switch from several highly cyclical sectors to consumer sectors with sustainable growth. In this section, we further expand the scope of our research on sustainable consumption growth by looking at a larger number of subsectors. Our methodology is to compare the penetration rate/per capita consumption of different subsectors with the world average.
- Our conclusion is that the most under-penetrated sectors, including life insurance, air traffic, cosmetics, online travel, medical equipment, and fragrances, should enjoy strong and sustained demand growth in many years to come.
- We highlight a few representative companies in these under-penetrated sectors. These include Ping An, Beijing Airport, Sa Sa International, Hengan, Ctrip, Mindray, and Huabao.

Ranking the penetration rate

The rule of S-curve theory -- demand growth accelerates at the early middle stage of product penetration (see Figure 28) -- is almost universally applicable in the consumer space. By comparing the penetration rates of consumer goods and services in China with the world average, it should provide a useful data set to assess the medium- to long-term growth potentials of various consumer sectors. The results of our comparison in 22 product categories are shown in Figure 29.

Figure 28: S-curve of consumer demand cycle



Source: Deutsche Bank

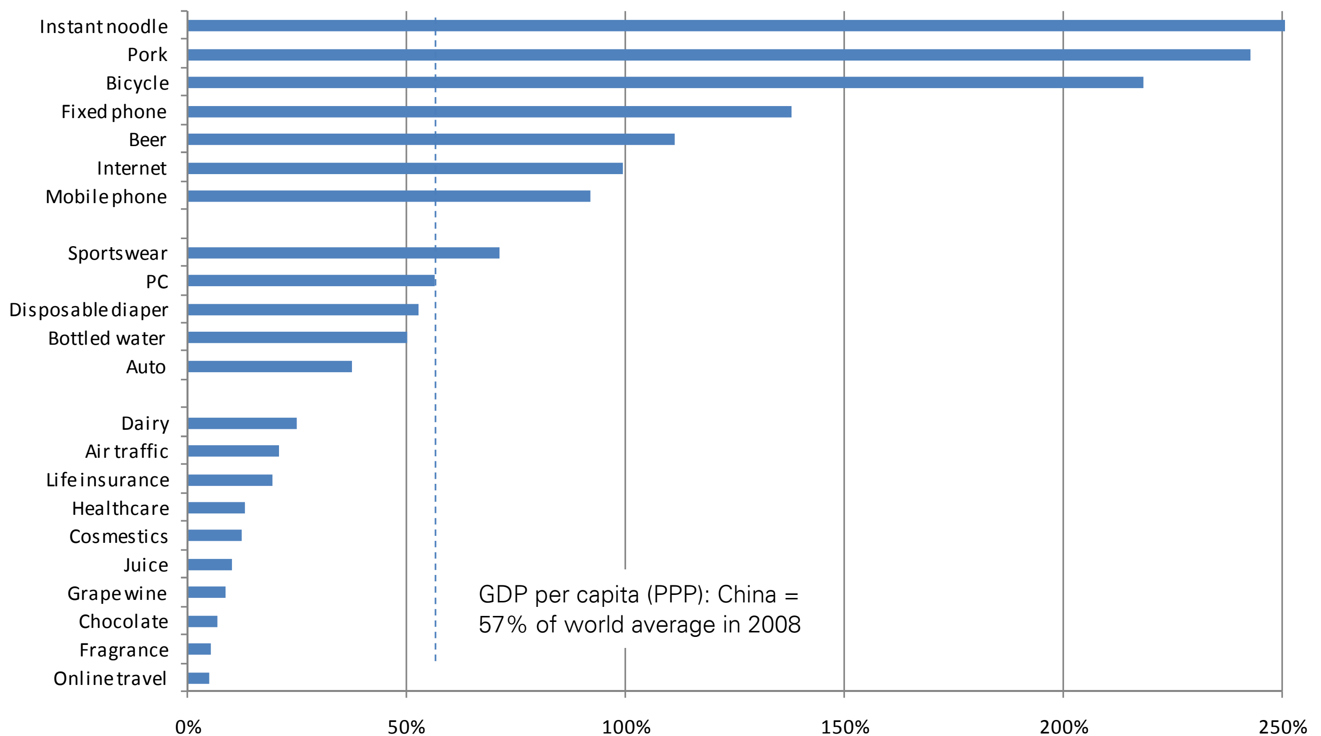
The sectors in Figure 29 can be categorized into three groups:

- **Mature markets:** the penetration rates of the seven products/services in the first group are higher than the world average level. These sectors, which include instant noodles, pork, bicycles, fixed line telephones, and beer, have passed their rapid-growing stage. Their demand growth rates as a percentage of household income are generally declining and are in the single digit category.

- **Partly developed markets:** the penetration rates in these five segments (sportswear, PCs, disposable diapers, bottled water, and auto) are between 50% and 100% of the world average, and in line with the average purchasing power of Chinese consumers as a percentage of the global average. In these product categories, sustainable demand growth should generally be in the neighborhood of 15%, in line with overall retail sales growth. Higher growth (e.g. over 20% per annum) can only be found in selected sub-segments in these sectors, for example, auto sales in tier-3 cities and disposable diapers in small cities and rural areas.
- **Under-penetrated markets:** the penetration rates or per capita consumption the ten products/services in the lower part of Figure 29are about one-quarter of the world average. These include dairy, air traffic, life insurance, health care, cosmetics, grape wine, chocolate, food flavor and fragrance, and online travel. Given that China's per capita GDP is about 57% of the world average, this means that Chinese consumption in these categories is still way below what it should be relative to its per capita income level. Given this significant under-penetration, we believe market leaders in these sectors should easily enjoy over 20% average annual growth in the next three to five years.

Certainly penetration rates or per capita consumption are not the sole determinates of growth potential at any single point of time. The dairy market, for instance, deviated from its high-grow track in 2008 due to the melamine incident. Auto sales growth, on the other hand, accelerated to an astonishing 80% yoy in recent months due largely to the one-off impact of policy stimulus and an extremely favorable base effect in the second half of last year.

Figure 29: Penetration rate/consumption per capita, China as % of world average



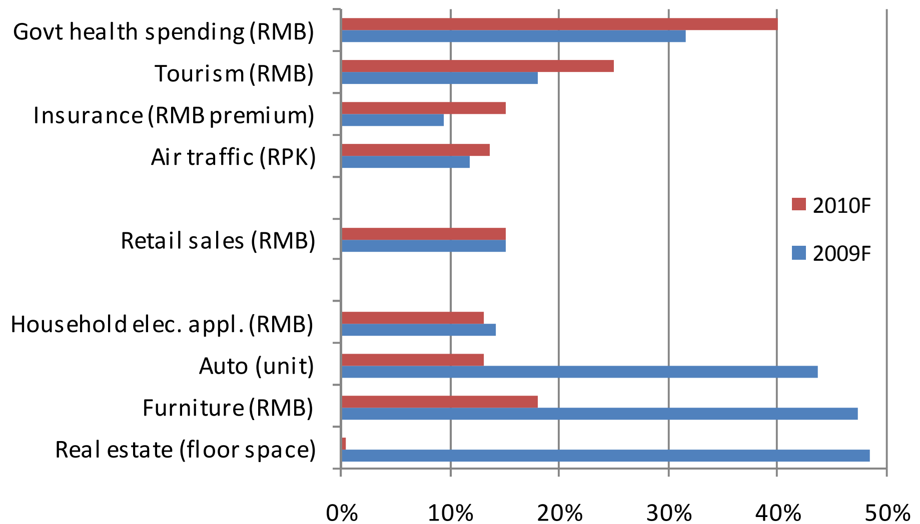
Source: Deutsche Bank, all data in 2008 annual consumption unless otherwise noted
GDP per capita: IMF
Instant noodle: package per capita; World Instant Noodle Association
Pork: carcass weight kg per capita; USDA
Bicycle: ownership per capita; http://www.america.gov/bikes.html, National Statistics Bureau of China
Fixed phone: lines per capita; Mobile phone: user per 100 people; Internet: user per 100 people; International Telecommunication Union, Ministry of Industry and Information Technology of China
Beer: Liter per capita; The Brewers of Europe
Sportswear: US$ per capita; Euromonitor 2006
PC: Ownership per capita; International Telecommunication
Disposable diaper: Total unit consumption divided by latent demand (3 pieces of diapers per day for each 0-2 year-old baby); China Household Paper Industry Association, Richer Consulting Services, Deutsche Bank estimates
Bottled water: gallon per capita 2007; Beverage Market Corporation
Auto: Ownership per 1000 people; CEIC, Alliance of Automobile Manufacturers
Dairy: Liter per capita; Deutsche Bank estimate based on International Dairy Federation 2006
Air traffic: passenger carried per 1000 people; Airports Council International, CEIC
Life insurance: US$ premium per capita; SwissRe
Healthcare: US$ expenditure (incl. both government and private) per capita; WHO 2006
Cosmetics: US$ per capita; China Association of Fragrance Flavor and Cosmetic Industries, survey of the Statistic Bureau of Luoyang, Henan Province (the city has similar income level to the national average);, Deutsche Bank estimate
Juice: liter per capita; China Juice Consumption Survey by CTR China (2007), Euromonitor, Deutsche Bank estimate
Grape wine: liter per capita; Tonghua Grape Wine 2007
Chocolate: US$ per capita; Euromonitor
Fragrance: US$ per capita; Euromonitor
Online travel: user per 100 Internet subscribers; iResearch, PhoCusWright, Deutsche Bank estimate

Divergence of consumption growth across sectors

Policy intervention tends to alter the short-term course of consumption growth and this has been particularly true in 2009. It will also affect the growth trajectory in 2010. Our view is that that surge in property and auto sales in 2009 – reflecting the excessive use and front-loading of policy stimuli -- implies much weaker growth rates in 2010. However, we believe demand in areas such as health care, travel, and many under-penetrated sub-sectors (as discussed above) will accelerate in 2010.

Figure 30 shows our projections of the divergence of growth performance in a variety of sectors. We estimate property floor space sales growth will decline to zero in 2010, down from around 50% in 2009. Auto sales growth will also likely decelerate to 14% in 2010 from about 44% in 2009. On the other hand, air travel, tourism revenue, and healthcare, and insurance premium growth will likely see 5ppt acceleration growth in 2010. The following sections discuss the rationale behind our forecasts.

Figure 30: Demand growth: underperformers in 2009 will likely outperform in 2010

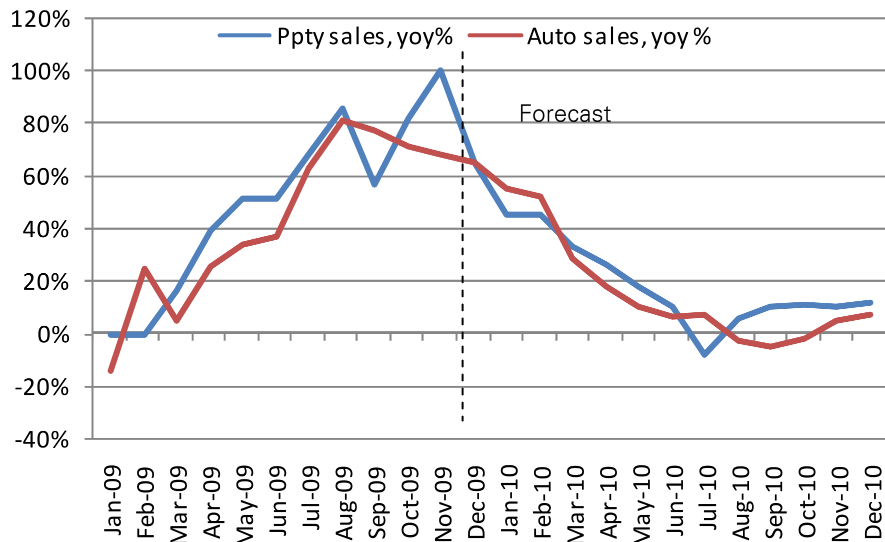


Source: Deutsche Bank, CEIC

Property and auto sales growth to slow sharply in 2010

Property floor space sales surged to 53% during Jan-Nov 2009, significantly higher than the historical average of 17% between 2000 and 2008. In November, floor space sales growth even overshot to 100%yoy. We regard this phenomenon, appearing in a "crisis year", as astonishing. It reflects a range of one-off policy-related factors: a total of 189 bps interest rate cuts between Sep 2008 and Jan 2009, cuts on various property transaction taxes at the end of 2008, and massive liquidity creation as evidenced by the 200% rise in net lending in the first half of 2009. Obviously, the low base in the latter part of 2008 also gave an artificial boost to the yoy growth rates in the second half of 2009. Our outlook for property sales growth on a monthly basis is depicted in Figure 31.

Figure 31: Property and auto sales growth forecast



Source: CEIC, Deutsche Bank estimates

Largely due to recent central and local policy measures to curb speculative demand, we expect property floor space sales growth in 2010 to fall to nearly zero. If interest rates are raised, which are in our baseline projection, yoy property sales growth will probably dive into negative territory at least for a few months in the year.

Auto sales posted a significant 80% yoy growth rate in recent months. This also reflected a few temporary catalysts. First, the tax cuts implemented from early 2009 significantly boosted sales of small cars (cars with engines smaller than 1.6 liters), which account for about 70% of passenger vehicle sales in China. The government has just decided to cut this tax benefit by half from 2010. Second, the "old for new cars" swap program, which was introduced by the middle of 2009 and is scheduled to last for 12 months, may continue to support sales in the first half of 2010 but its impact will diminish over time. Third, the base effect was extremely favorable for yoy growth in H2 2009, but will become highly negative for yoy growth in H2 2010. Finally, the rise in oil prices is beginning to hurt consumer sentiment, as evidenced by much weaker gasoline production growth[2] at 8.1% in the first three quarters of 2009 vs. auto sales growth. Given these factors, we expect auto sales growth to slow to 14% in 2010, down from 44% in 2009. A monthly trajectory will look like that in Figure 31. By Q3 2010, yoy auto sales will likely fall to zero or a slight negative, 80ppts down from the recent peak.

Travel, healthcare, and insurance spending will likely accelerate

In travel-related sectors, we expect acceleration in growth partly on the very recent introduction of policy stimulus. On Nov 25 2009, the State Council issued its policy guideline to accelerate the development of the tourism industry. Under this guideline, the government will lower entry barriers to private and foreign capital, increase investment on tourism infrastructure, and speed up the restructuring of state-owned travel companies. More implementation details should follow in the coming months. Specific measures may include further relaxation of visa restrictions (especially between the Mainland and Hong Kong/Macau), more duty-free shops, subsidies for ticket prices at tourist attractions, free tourism coupons, incentive travel as part of SOEs' employee benefits.

Healthcare spending should also accelerate growth in 2010 due to the earlier delay in reforms. The Notice on Reform of the Pricing System of Drugs and Medical Services, issued by the NDRC on Nov 23 2009, finally sets the stage for changes to the hospital procurement system (which should favor medical equipment over drugs), distribution channels (likely to accelerate consolidation of drug distributors), and expansion in health insurance coverage.

Insurance premium growth dropped to a single-digit level in 2009, down from 39% in 2008. Key factors behind this deceleration include the decline in households' investment confidence and the industry-wide reform, which shifts the focus from bancassurance products to longer duration regular premium individual products. In 2010, with the new insurance law now in effect and rising interest rates providing life insurers with better pricing ability, insurance premium growth will likely reaccelerate to around 15%.

Selected beneficiaries

Some of the names mentioned in the consumer basket we proposed in our Oct 19 report on "From Cyclicality to Sustainability" now look fully valued. Based on our top-down analysis of consumer penetration and our latest bottom-up study on valuations and company level catalysts, we now discuss a few representative beneficiaries from under-penetration as well as catalysts. These companies include Ping An, Beijing Airport, Hengan, Mindray, Ctrip, and Huabao.

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[2] Based on data from PetroChina and Sinopec.

Figure 32: Representative companies in the under-penetrated consumption sectors

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	PE 2010	EPS CAGR 09-11	PEG (10PE/EPS 09-11	Revenue growth 2009	Revenue growth 2010
Ping An Insurance Grp	2318.HK	Insurance	Buy	68.0	66,542	26.0	30%	0.86	16%	11%
Sa Sa International	0178.HK	Retailing	Buy	5.1	440	19.3	19%	1.02	5%	14%
Hengan Intl.	1044.HK	Household & Personal Prc	Buy	57.6	9,073	27.8	24%	1.16	22%	26%
Huabao Int'L	0336.HK	Materials	Buy	8.4	2,333	20.0	20%	0.99	37%	24%
Ctrip.Com International Lt	CTRP.OQ	Consumer Services	Buy	71.9	4,880	39.4	38%	1.03	34%	45%
Beijing Cap Int'L Airport	0694.HK	Transportation	Buy	5.1	2,832	31.1	106%	0.29	12%	16%
Mindray Medi-Adr	MR.US	Medical equipment	NR	31.3	3,377	20.1	25%	0.82	13%	21%
Average					12,783	26.2	37%	0.70	20%	23%
MSCI China						17.4	18%	0.97		

Source: Deutsche Bank, Bloomberg for Mindray; Note: 1. Hengan acquired Qinqin Food in 2008. For comparable purpose, its 2009 revenue growth is calculated excluding Qinqin's sales in both 2008 and 2009. 2. For non-rated stocks (NR), we use Bloomberg consensus estimates for EPS, PE and revenue calculation, The NR stocks are not covered by Deutsche Bank's fundamental research and consequently we make no representation to the quality of the business, assets or management.

Following are the brief discussions on these companies.

Life insurance – Ping An (2318.HK, Buy, HK$68)
Data from Swiss Re indicates that in 2008 China's life insurance penetration (premium as a percentage of GDP) and density (premium in US$ per capita) are respectively one-half and one-sixth of the world average. The outlook for penetration/density improvement, the recovering economy, further policy support (e.g. the tax cut on insurance products that the Shanghai government recently announced) and the favorable base effect should bode well for premium growth. We expect life insurance premium growth to accelerate from 6-7% in Jan-Oct 2009 to mid-teens in 2010.

More importantly, the escalating inflation concern provides another strong catalyst. Nearly 80% of major life insurers' investment portfolios are fixed-income and term deposits. If rate hikes do not provoke a major correction in the equity market, the investment yield should improve by approximately the same magnitude (81bps in our central scenario for deposit rate hikes). Deutsche Bank insurance analyst Bob Leung estimates that for every 50bp increase in investment yield, China Life and Ping An's Value in Force and New Business Value would rise by up to 20%.

Ping An will be more sensitive to interest rate hikes than China Life due to its legacy premiums written in high-interest periods (up to 30% of its statutory life insurance reserves are related to these negative spread policies). Ping An's shorter asset duration means that its trading portfolio is less negatively affected by rate hikes. Bob Leung also prefers Ping An for the value-accretive Shenzhen Development Bank transaction and its more attractive valuation.

Air traffic – Beijing Capital International Airport (BCIA, 694.HK, Buy, HK$5.14)
In 2009 Chinese airlines carried about 230m passengers, equivalent to 17% of the country's population. This ratio, according to the statistics of Airport Council International, is only one-quarter of the world average. In other words, China's air travel market is still at an early stage of development. Deutsche Bank sector analyst Vincent Ha expects the long-term sustainable growth potential to be 1.5 times GDP growth, or around 15% per annum in the next few years.

In 2010, positive catalysts for the sector include: 1) the completion of some expansion projects in major air-hubs, including the new terminals of Shanghai Hongqiao Airport, Chongqing Airport and Changsha Airport; 2) a recovery in domestic and global economies, as well as airlines' profitability; 3) RMB appreciation; and 4) new policy stimuli to boost domestic travel (the outline of the policy was approved by the State Council on November 25, 2009 and more implementation details will be issued in the coming months).

At the company level, Vincent Ha believes the current valuations of the major airlines are demanding; but BCIA provides a good leverage into air traffic growth with a reasonable valuation. He estimates that for every 1ppt change in 2010 pax traffic growth the net profit of BCIA would increase 4.6%. The market could be misled by its PE valuation, which is distorted by the huge depreciation associated with its recent capex on the new terminal. On a free cashflow basis, its yield of 12-13% over 2010-2011E is ahead of the Chinese airlines and most other infrastructure companies in the region.

Cosmetics – SA SA International (178.HK, Buy, HK$5.14)

During Jan-Oct 2009, the retail sales of cosmetics companies[3] increased by 24%, after five years of over 20% annual average growth. Yet on a per capita basis Chinese consumers only spend one-seventh of the world average on cosmetics, according to the Association of Fragrance Flavor and Cosmetic Industries.

For high-end foreign cosmetic brands, Hong Kong is the ideal shopping destination due to the 30-50% price advantage (as imported products are tax free in Hong Kong), a wider selection of products, and its good reputation of product safety and authenticity. SA SA International, the leading cosmetic retailer in Hong Kong, generates around 50% sales from Mainland visitors. Deutsche Bank consumer analyst Anne Ling has a Buy rating on the company on the back of its solid sales momentum. The company has become more aggressive in its store opening plan recently. Anne Ling also likes its high dividend yield (7.6% in FY11E) and a proven track record in improving product mixes promptly.

The short-term catalysts for the company include improving domestic consumer confidence, RMB appreciation, inflation, and possibly further relaxation on visa application for Mainland tourists to Hong Kong.

Medical equipment – Mindray (MR.US, NR, US$33.9)

According to the World Health Organization, China's healthcare care spending is 27% of world average on a PPP basis. Though it is technically complicated to make an international comparison on penetration of medical equipment, the current healthcare system in China is obviously skewed to the use of pharmaceutics rather than medical devices and equipment, a problem that the on-going reform aims to remedy.

As explicitly required by the Ministry of Health and the NDRC on Nov 24, 2009, one key element of the healthcare reform is to cap drug prices and to increase the medical service fees. We expect that a new pricing schedule on service fees to be announced within the next six months. Due to the delay in the implementation of the drug price reforms (the announcement of the Basic Medicine Catalog came in mid-August, four months later than MoH's earlier expectation), we believe a larger part of the RMB850bn health reform budget will be spent in 2010 and 2011, resulting in a more positive impact on demand for medical equipment from 2010.

Mindray is China's largest listed company in the sector. It is also the third-largest player in the global patient monitoring devices market. In 1H09 it generated 50% of revenue from foreign markets, while developed markets are responsible for 20-25% of its total sales. That said, Mindray's patient monitoring devices have a 49% market share in China. The other product lines also enjoy leading positions with a 30-40% share in the domestic market. China's back-loaded health expenditure and our expectation of a forthcoming recovery of US hospital

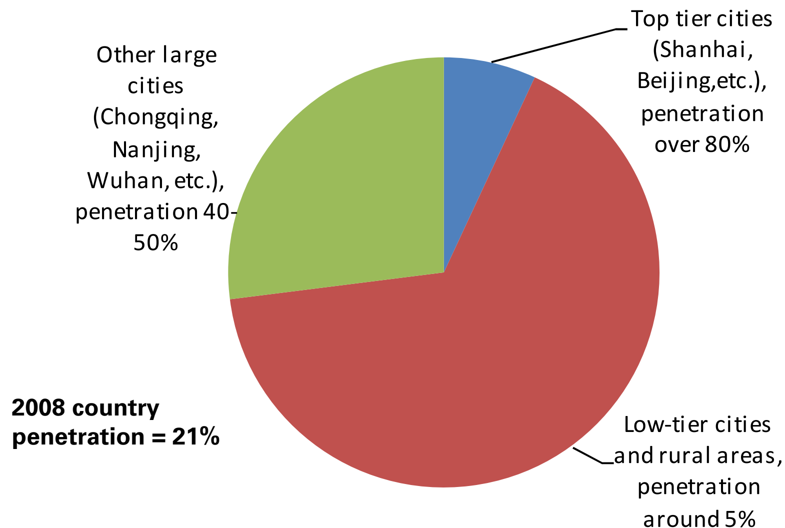
[3] Companies with annual revenue over RMB5m.

capex budgets are two potential drivers for Mindray's earnings growth in the next one to two years. The Bloomberg consensus expects the company's top-line growth to accelerate to 21% in 2010 from 13% in 2009. The PEG ratio is 0.9 based on the consensus FY09-11E EPS CAGR of 24% and FY10E PE of 22x.

Disposable diapers – Hengan International (1044.HK, Buy, HK$57.6)
China's penetration ratio of disposable diapers is 21%, about half of the world average and much lower than the 95% penetration in developed countries. The industry's total revenue reached RMB12bn in 2008 in China with over 35% 2003-08 CAGR. At this stage of market development, we believe overall growth will start to slow modestly but the under-penetrated segments – especially in rural areas and small cities – can continue to grow at an annual rate of 40%.

Over the past few years, the exponential growth was mainly contributed by large cities, reflecting the rapid expansion of the population of middle class parents. This group of young consumers is very receptive to the benefits of disposable diapers compared with traditional cloth diapers. Small cities and rural areas, though twice as large in terms of population compared with big cities, are still poorly penetrated due to relatively lower income levels (see Figure 33). We estimate that in lower tier cities and rural areas, which have a population of nearly 900m people, the penetration ratio of disposable baby diapers is only 5%.

Figure 33: Penetration ratios of disposable diapers in different regions in 2008



Source: Deutsche Bank, China Household Paper Industry Association

A short-term catalyst is the recovery of export sectors, which employ tens of millions of rural migrant workers. Influenced by the life style in urban families, this group of consumers is very helpful in increasing the usage of disposable diapers in their hometowns. If the big city experience provides any guide, the small city and rural market penetration rate will likely rise exponentially from the current 5% to about 20% within the next four years. Taking into account price inflation, this means that the small city and rural market will expand at an annual average of 45% per year for the next four years, and the industry's sales growth overall should maintain an annual average growth of close to 20% during the same period.

Measured by market share, Hengan's Anerle is second largest baby diaper brands in China. The company's diaper sales increased by 30% per annum over 2005-08, beating the industry average of 26%. Deutsche Bank consumer analyst Mabel Wong believes that Hengan has been gaining market share from low-tier cities and rural regions with 9,000+ salespersons across China, as well as a wider range of products to suit low-end diaper markets. Mabel Wong forecasts that Hengan's diaper sales will continue to grow strongly by 28% per annum in the next two years. The company is trading at 27.7x FY10E PE with an estimated 2009-10 EPS CAGR of 21%.

Online travel – Ctrip (CTRP.US, Buy, US$71.9)
China's tourism sector – measured by revenue -- has been growing at 17% CAGR since 2001. Overall travel agency revenue reached RMB166.5bn in 2008 but online travel service providers only receive a tiny proportion. According to the industry intelligence company iResearch, the market size of online travel reservations was only RMB2.8bn in 2008 and RMB1.6bn in 1H09. Only 2% of the Internet population are users of online travel services. In contrast, the online travel agencies are responsible for 50% of the travel revenue in US and 30% in developed European countries. If one assumes that the online travel service's market share in China will increase from the current 2% to 5% by 2012, the market size for online service providers should reach RMB15.6bn between 2008 and 2012, representing a CAGR of over 50% for the coming few years.

Several underpinning trends should support this growth story. First, the number of Internet users in China will continue to grow rapidly, at an annual average rate of 16% in the next three years according to CNNIC. Second, the majority of the travelers are tourists or businessmen who are receptive to and capable of using online services. Third, the convenience and cost-efficiency of online booking of air-tickets and hotels have been impressive, and are becoming a major reason for attracting more customers.

In our view, the recently announced policy stimulus on travel, massive infrastructure investment (on transport and tourism sites) and strong auto sales will serve as short- to medium-term drivers for the travel sector.

Ctrip remains the indisputable leader in China's online travel service, holding the lion's share of the market – it had 56% of the market in 2008. Its closest rivals are Elong (with a 13% market share) and Mangocity (7%). Over the past three years, despite fierce competition, Ctrip has increased its market share from 51% to 57%, mainly gaining from the second and third players. Ctrip has a solid grip on its existing market share with (1) economies of scale, (2) a loyal customer base, and (3) exemplary service quality. Ctrip has signed agreements with all 5-star hotels, 80% of 4-star hotels, and 75% of airlines. About 80% of its transactions are from returning customers. Ctrip is currently trading at 40.0x 2010E PE. Our analyst Alan Hellawell expects its EPS to grow at a 29%CAGR during 09-11E, driven by sustained volume growth and further market share expansion.

Huabao International (336.HK, Buy, HK$8.4)
Food flavors and fragrances are also near the bottom of our penetration ranking in Figure 29. Huabao provides unique exposure to the flavors and fragrance sector, though only 15% of its FY09E revenue comes from fast-growing food flavors and fine fragrance segments (over 35% yoy sales growth in FY10E) and the bulk (85% of sales) remains in the less attractive tobacco flavor segment. In terms of contribution to the company's earnings growth, Deutsche Bank consumer analyst Mabel Wong believes that 22% will come from food flavors and fine fragrances products within the next two years. Mabel Wong also likes Huabao's cash-generative business model, special dividend and new business initiatives. The company is trading at 19.9x PE, vs. 20% EPS CAGR during 09-11E.

Other sub-sectors to watch
There are no listed Chinese chocolate manufacturers under our coverage, except China Food (506.HK, Buy, HK$7.0), which has 2% sales exposure to the confectionary segment. However, Swiss chocolate giant Barry Callebaut (BARN.SE, Hold, CHF653) highlighted the significant growth potential of the Chinese market in its business outlook briefing.

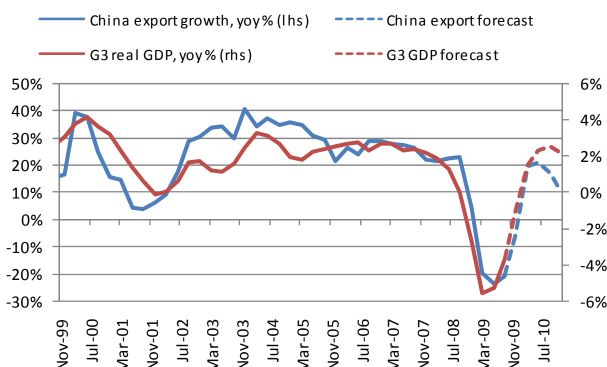
Theme #3: Export recovery in a flying-geese pattern

- With China's headline export growth recovering strongly, we believe that the China equity market will soon (probably within the next few months) price in most of the growth upside of the first batch of the beneficiaries, including container shipping, ports, and exporters of consumer goods such as textiles, apparels, shoes, and electronics.
- However, the performance of various export-related sectors will likely be in a flying-geese pattern. We identify at least three waves of the recovery based on historical correlations and capacity utilization changes. In our view, the first wave (from mid-2009 to mid-2010) involves container shipping, ports, trading, and export manufacturing in the textile, electronics, furniture, shoe and toy sectors; the second wave (starting from end-2010) should include port machinery; and the third wave (starting from 2012) will include shipbuilding.
- The obvious equity market implication is that investors should, over the coming year or so, gradually switch some of their export holdings towards the beneficiaries in the second and third waves of the recovery, i.e., port machinery makers and shipbuilders.

The first wave: container shipping, ports, exports of consumer goods

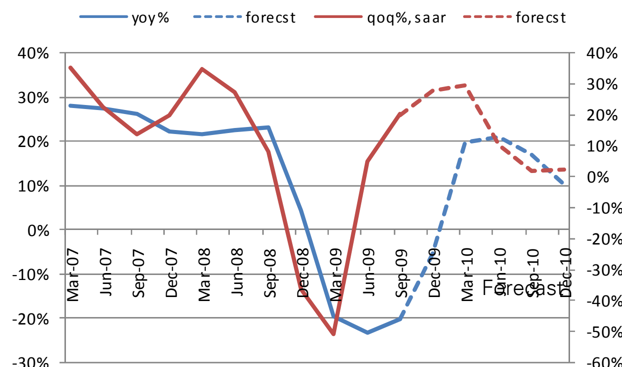
China's export growth hit the bottom in May 2009 on a yoy basis and we expect it to recover strongly towards 20% in Q2 2010. On a qoq basis, we now expect sequential export growth to peak in Q1 2010. On an annual average basis, we forecast export growth to reach 16% in 2010, up from -15% in 2009 (see Figure 34 and Figure 35).

Figure 34: China exports highly correlated with G3 GDP



Source: Deutsche Bank, CEIC

Figure 35: China export growth forecast



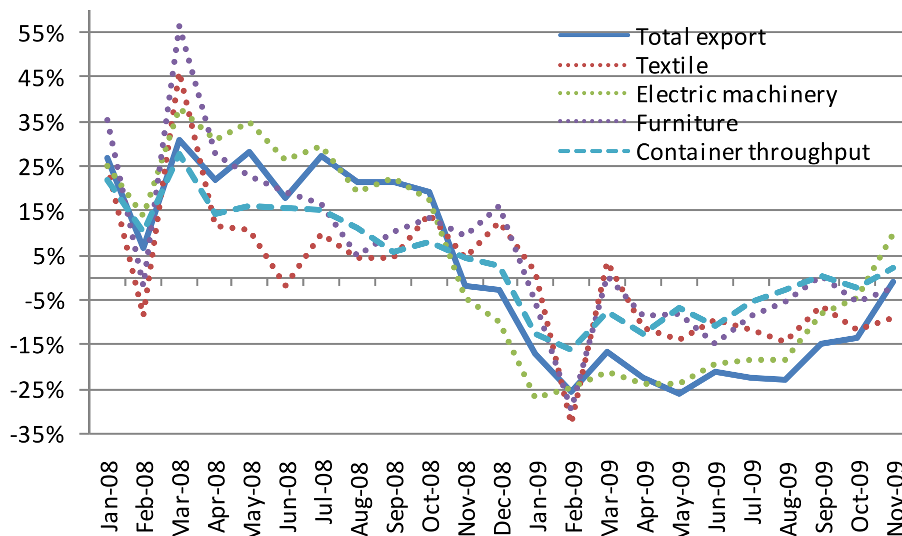
Source: Deutsche Bank, CEIC

Historically, container shipping throughput and exports of consumer goods show roughly the same trajectories for their cycles (see Figure 36). The market has reflected a large part of the rebound in these sectors, as evidenced by the outperformance of our "export basket"[4] over

[4] The "export basket" was published in our report "Exports to outperform FAI in next 12 months" dated on 29 June 2009. The constituents are representative companies in typical export sectors – Li&Fung (494.HK), Alibaba (1688.HK), BYD (1211.HK), China Merchant (144.HK), China Shipping Container (2866.HK), Foxconn (2038.HK), Yue Yuen (551.HK) and Lenovo (992.HK).

the HSCEI index. Since we now believe that the peak of sequential export growth may be delayed by one quarter to Q1 2010, these export-related sectors should continue to perform positively for a few more months. But from Q2, when sequential US economic growth begins to decelerate, the share prices of these companies will likely lose steam

Figure 36: Rebound of typical export sectors



Source: Deutsche Bank, CEIC

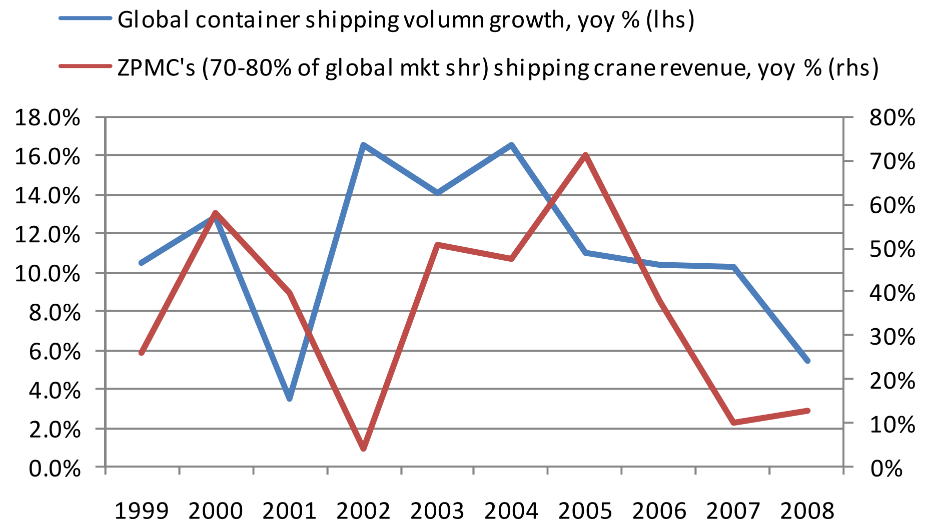
The second wave: port machinery

The port machinery industry is a laggard of the global shipping recovery. The revenue of the sector will likely hit the trough in H2 2010.

Typically, container shipping traffic recovery is concurrent with export recovery but port infrastructure investment is a laggard until the port utilization rate reverts to the normal level. In the past year, many ports around the world postponed their new construction or expansion plans. For instance, the Dubai Port Group announced it would delay its US$2.2bn London project in March and its US$1.5bn Jabel project in July 2009. The Mexican government also suspended its US$5bn project in February 2009. Given the delay and cancellation of many port expansion plans, and the recovery of shipping traffic seen from mid-2009, we expect port utilization rates to normalize towards the end of the 2010. By then, port investment should begin to pick up.

The port machinery demand cycle closely tracks the port investment cycle, which lags the shipping traffic cycle by only 1.0-1.5 years. This is confirmed by company data of the world's largest port machinery company Chinese ZPMC, which has 70-80% of global market share (see Figure 37). Given that global trade already hit the trough in mid-2009, we expect order flows for port machinery to bottom-out from H2 2010.

Figure 37: Port machinery sales lag container throughput by 1-1.5 years



Source: Deutsche Bank, ZPMC annual reports, CEIC

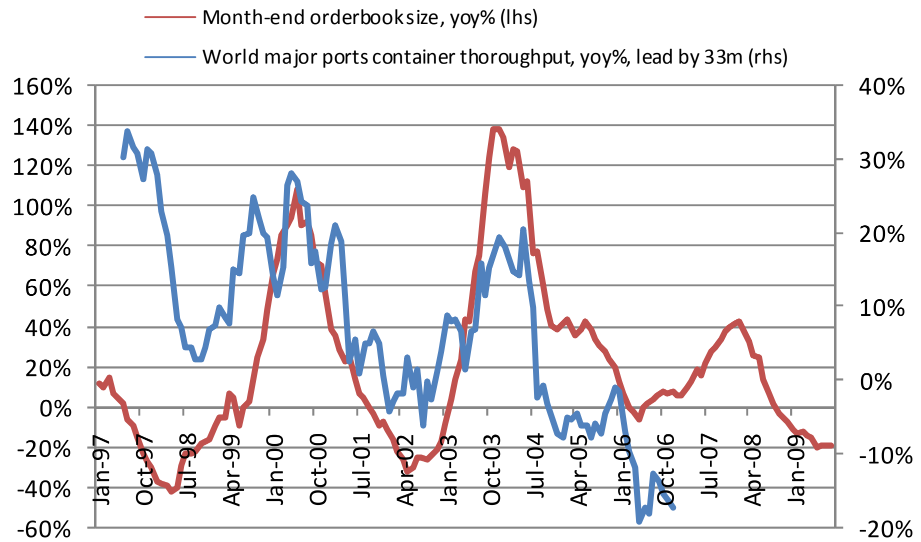
Shanghai Zhenhua Heavy Machinery (a.k.a. ZPMC, 900947.CH, NR, US$0.8)
Zhenhua is the world's dominant port container crane manufacturer. Its global market share has grown from 30% in 2000 to 78% in 2008. The company was hit hard by the slump in global port investment after the financial crisis. In the first three quarters of 2009, the company's net profit dropped by 44%, despite the contribution from the fast-growing off-shore heavy-duty equipment segment (which accounted for 31% of operating profits in 1H09 vs. 5% in 1H08). Bloomberg consensus forecast looks for -45%, 14% and 26% EPS growth in 2009, 2010 and 2011, respectively. The company is trading at 24x 2010 consensus earnings.

The third wave: shipbuilding

Due to its lengthy production cycle, the shipbuilding sector is probably the most lagged beneficiary of export recovery. We think order books will recover only from 2012-13.

Historically, the cycle of container throughput led shipbuilders' order book by around 33 months (see Figure 38). This is because shipyards usually need two to three years to absorb excess capacity after a decline in demand for vessels.

Figure 38: Global container shipping throughput (led by 33m) vs. shipyard order book



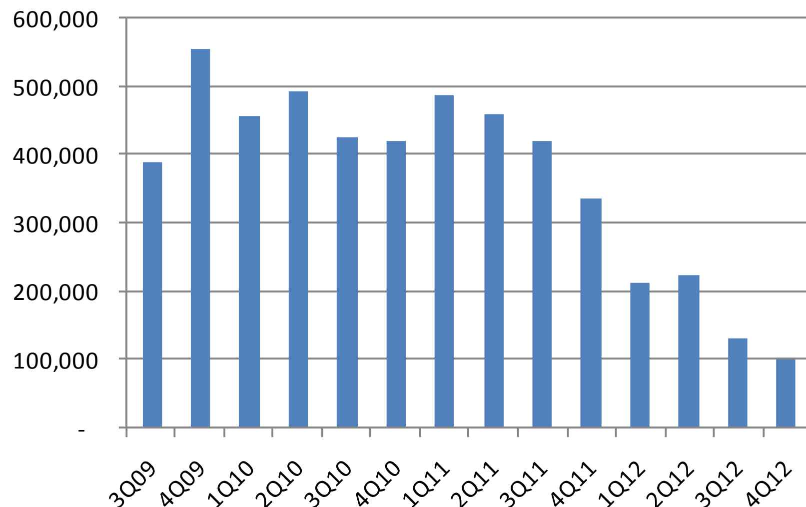
Source: Deutsche Bank, compiled from port data of Los Angles, Long Beach, Shanghai, Hong Kong, Singapore and Busan

If historical experience still provides a guide, then the timeline of the industry's business cycle could look like the following:

- Mid-2009: trough of container shipping traffic
- End-2011: trough of shipyards' order book
- End-2013: trough of vessel delivery

Currently the oversupply of both shipping capacity and shipbuilding capacity remains the major overhang for shipping rates and vessel prices. Deutsche Bank conglomerates sector analyst Kevin Chong wrote in his November note that "on an annualized basis, 2009 industry new orders are down 85% yoy and this weakness should continue due to the significant oversupply situation"; "the global new orders should deteriorate further as we move into 2010, where the majority of order book is expected to be delivered. Currently, worldwide order book stands at 8,132 vessels totaling 510m dwt (or 42% of the global fleet, versus an average of 5-14% over the past 20 years)".

Figure 39: Global container ship delivery schedule, TEU



Source: Deutsche Bank, Clarkson

Although Chinese shipyards are also suffering from the decline and cancelation of orders, they should gain substantial market share from Korean and Japanese competitors during the downturn. The competitive advantages of Chinese shipyards include:

1) The greater potential to catch up on productivity and technology: for instance, Chinese shipyards currently take 300%-400% more working days to assemble vessel blocks than leading Korean and Japanese shipbuilders. The scope for huge productivity growth should provide substantial price competitiveness to Chinese shipyards;

2) The cost advantage: besides the widely-known lower labor costs in China, Chinese shipyards enjoy better and lower cost supply of raw materials. Korea and Japan rely heavily on imported ship steel plates but most Chinese shipyards source steel products domestically;

3) Government support: The Chinese government moves aggressively to eliminate excess shipbuilding capacity with administrative measures, which should help consolidate the position of large players in China.

Figure 40: Global market share of Chinese shipyards

Source: Clarkson

Guangzhou Shipyard International (317.HK, NR, HK$13.2)
Guangzhou Shipyard is the largest shipbuilder in Southern China. Its major products, the handy-size vessels, account for around 15% share of global market. As of end Q3 2009, the company has an order book of 57 vessels of a total tonnage of 2.4m DWT (over four times of its current annual capacity) and a full production schedule till 2012.

In his report on *Handysize Sailing Ahead* dated 23 September 2009, Deutsche Bank marine transport analyst Joe Liew indicated that 57% of global handysize fleet is over 20 years old and hence the incentive to scrap is increasing. Moreover, handy-size vessels are easier to build compared with larger vessels, but many small greenfield shipyards find it difficult to obtain financing in times of the crisis. Joe Liew expects demand for handy-size transport to recover in 2010 along with global GDP growth and supply (i.e. the delivery of handy-size vessels) to resume growth in 2011. This is likely to be one to two years ahead of the recovery in delivery of other types of vessels.

Guangzhou Shipyard is trading at 8.8x consensus 2010E earnings (Bloomberg). Consensus forecasts are for EPS to grow 10% in 2010 and to fall by 4% in 2011.

Theme #4: 45% carbon reduction

- China has promised to cut carbon emission by 40-45% per GDP unit before 2020. To achieve this aggressive target, it will focus on reducing emissions from coal-fired power plants, as these account for 50% of China's carbon emissions, and on significantly increasing the percentage contribution of wind and nuclear to total power production.
- We see great potential for wind, nuclear and IGCC (Integrated Gasification Combined Cycle) equipment manufacturing, as key beneficiaries of China's drive to reduce emissions. Smart power grids, as the necessary infrastructure for wider use of alternative energies, should also enjoy rapid demand growth in the coming years.
- We are cautious on the outlook for solar power and green cars, as they are far from economically competitive given foreseeable technology progress in the coming years.

Overview

Just before the Copenhagen conference, China's State Council announced the country's target to reduce carbon dioxide emission per GDP unit by 40-45% in 2020 from its 2005 level. This is an aggressive target for a fast-growing large economy (see Figure 41). Mr. Zou Ji, former head of China's climate negotiation team, said that China's target implies 1ppt reduction in China's annual GDP growth potential for the next 15 years.

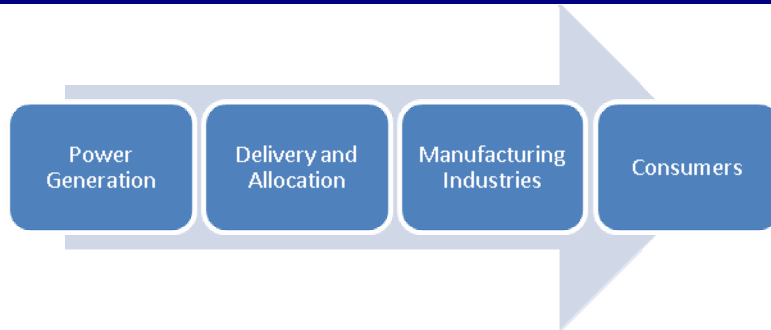
Figure 41: CO2 emission reduction targets set by top emitters

	CO2 emimssions as % of world total	2020 self-set target
China	21.5%	40-45% density cut from 2005 level
US	20.2%	17% level cut from 2005 level
EU	13.8%	20% level reduction from 1990 level
Russia	5.5%	22-25% level reduction from 1990 level
India	5.3%	20-25% density cut from 2005 level
Japan	4.6%	25% level reduction from 1990 level
UK	2.0%	34% level reduction from 1990 level
Canada	1.9 %	20% level reduction from 2006 level
ROW	27.1%	

Source: IEA, Deutsche Bank compiled from media reports; Note: 1. density refers to Co2 emission by GDP unit; 2. these self-set targets are not legal binding

We think the government will resort to alternative energies, energy-saving and waste treatment technologies to reach the target. These include nuclear power, wind power, smart power grids, and electric automobiles. We show a general picture of the industrial chain involved in the so-called "low carbon economy" in Figure 42. Theoretically, all participants in the low carbon chain are likely to be beneficiaries of the government drive.

Figure 42: Industry chain of "low carbon economy"



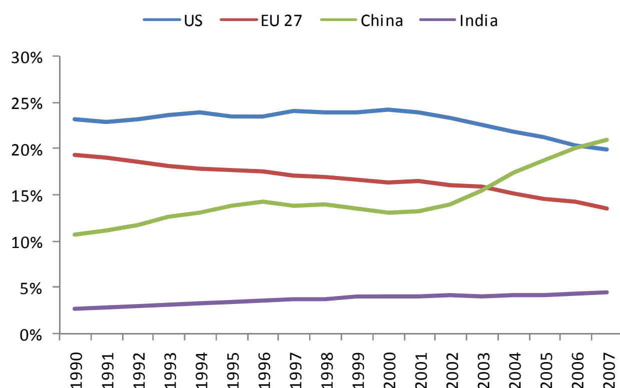
Source: Deutsche Bank

However, in reality, only some of them that can overcome the technology hurdles, produce products at reasonable costs, and achieve sufficient carbon reductions will be the ultimate winners. For investors, it is also important to gauge to what extent the current valuations have priced in this potential growth outlook. Based on our analyses, we believe the most interesting beneficiaries should include nuclear equipment, wind equipment, coal gasification equipment, and smart grids. On the other hand, solar power and electric cars are not yet economically feasible or still face critical technology hurdles.

Carbon emission structure and reduction potentials

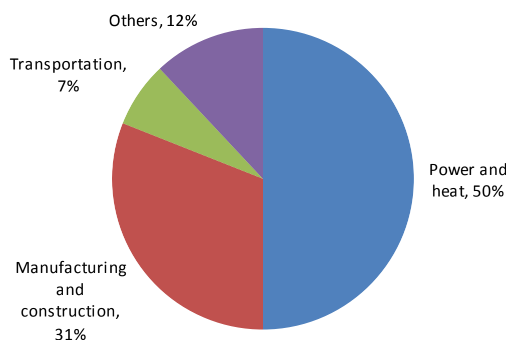
China generates 21% of world total CO2 emissions (IEA data of 2007), higher than the US share of 20% (Figure 43). China is thus under significant pressure to reduce its carbon footprint. How is China going to do it? The breakdown of China's CO2 emissions will give a fairly straight forward answer. In Figure 44 we show that 50% of China's carbon emissions come from power & heat generation, 12% from steel production, 6% from non-metal manufacturing, and 7% from transportation. These are obviously the key sectors that the government will focus on in its carbon reduction endeavors.

Figure 43: County CO2 emission as % of world total, 2006



Source: IEA

Figure 44: China CO2 emission by sector, 2006



Source: IEA

Major beneficiaries

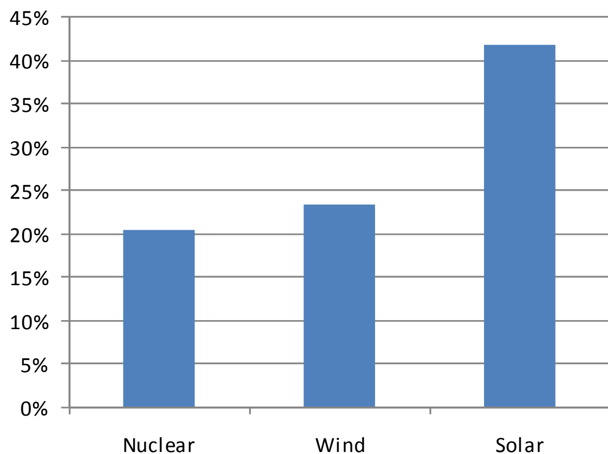
We believe that IGCC, nuclear, wind, and smart grids are the most interesting beneficiaries of China's drive to reduce carbon emissions.

Power generation IGCC technology

Clearly, the power generation sector is of utmost importance in achieving China's objective of carbon reduction. There are primarily two ways to cut carbon emissions in the power generation sector. One is to make more use of alternative energies such as solar, wind and nuclear power. China has already announced its plan to increase the share of non-fossil energies in total primary energy from 8.8% in 2009 to 15% in 2020. The other way (perhaps more effective in the short run) is to cut CO2 emission per unit of coal fired power generation. According to the IEA (2006), 80% of power generation in China is coal fired, compared with the world average of 40% (Figure 46). This is not surprising as China owns 34% of the world's total coal reserves.

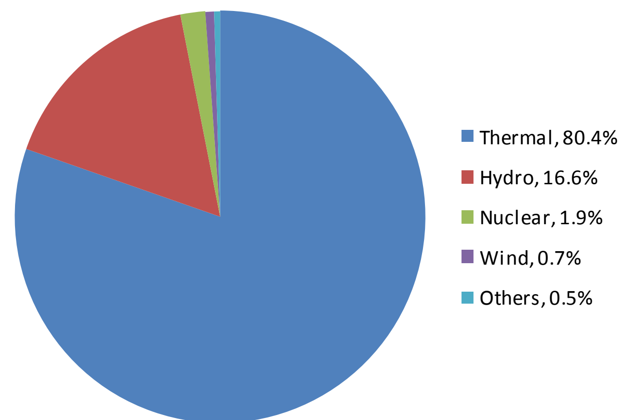
The problem is that coal-fired power generation emits a large volume of CO2: according to the IEA, carbon emissions per kwh generated by coal-fired plant are 1.6x those of oil-fired plants and 2.0x those of natural gas-fired. What is worse is that China's power plants are less efficient, consuming 15% more coal equivalent per unit of power generation than power plants in the West. Technology improvement is the solution. IGCC (integrated gasification combined cycle) technology can help China's power plants reduce carbon emission by 10%. Although IGCC implementation will also increase the unit cost of power generation by 20-30%, this would still be economically competitive relative to other renewable energy sources such as wind or solar power. IGCC equipment and technology providers should thus be a major beneficiary.

Figure 45: Expected capacity growth rate, 2008-2020



Source: NDRC

Figure 46: China electricity production by energy sources, Jan-Nov 2009



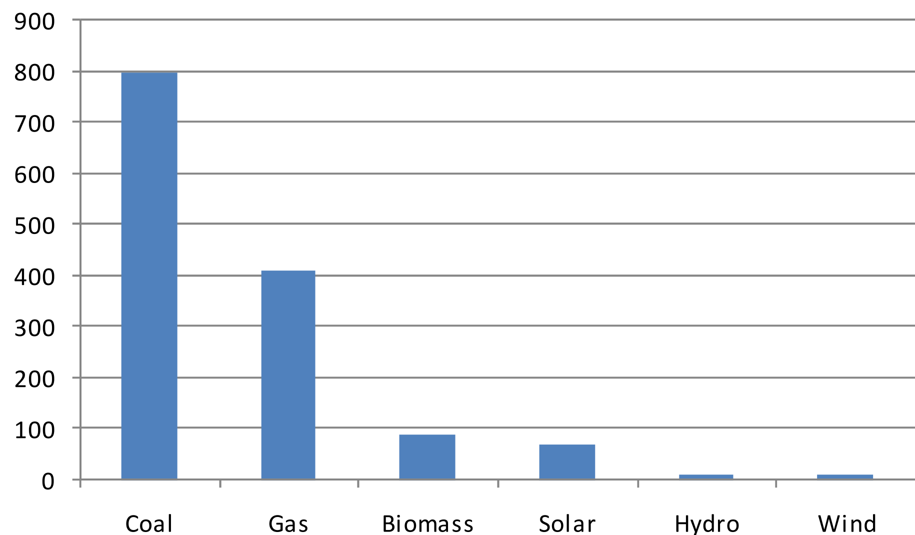
Source: China Electricity Council

Wind and Nuclear

The second important approach to reducing carbon emissions in the power sector is to switch to alternative energies. By the end of 2010, the government will likely promulgate the long-awaited "New Energy Industry Renovation Plan", which should set much more aggressive targets for than those in September 2007. We estimate total investments (including public and private) in alternative energies could amount to close to RMB5tn by 2020.

We believe the alternative energy sectors with the greatest potential would be nuclear and wind power for two reasons. First, they are relatively under-developed in China, in terms of share in total energy production. For example, nuclear power accounts for 15% of world power generation, while its share in China is only 2%. Second, given current technologies, wind and nuclear are much more cost competitive than solar. The average cost for solar power is about RMB2/kwh, compared with RMB0.55/kwh for nuclear and wind. Even optimists forecast that solar power's cost will decrease to only RMB0.8/kwh in 2011.

Figure 47: Carbon emission from power generation by energy source, gCO2/kwh , 2006



Source: UK Parliamentary Office of Science and Technology

Strong smart grids

Power needs to be delivered and allocated to end users. Alternative energies, by nature, are volatile in output and frequency, thus it is difficult to plug them into the current power grids. The new generation of "smart grids" can help streamline the delivery network and make electricity generated from alternative sources more economically available to end users. In addition, smart grids can help smooth out the peaks and troughs in electricity end–demand, thus improving efficiency. In May 2009, the State Grid Corporation of China (SGCC) announced a development plan for "Strong Smart Grids". The plan is divided into three phases: an investment of RMB550bn for 2009-2010, RMB2000bn for 2011-2015, and RMB1700bn for 2016-2020. Among these, direct investment in smart grids will be about RMB67bn each year from 2009 to 2020. Power equipment makers with the right technologies (e.g. providers of ultra-high voltage facilities and IT equipment) should be major beneficiaries

Other players

Following power generation, the second largest group of carbon polluters in China are the manufacturing industries, especially steel and non-metal material manufacturing. Currently, China's industrial energy efficiency is on average 30% poorer than the world's advanced levels, so there is significant room for improvement. The government has set a target to improve energy efficiency by 20% during the 11th five-year plan. Providers of energy-saving technology and equipment to industrial companies should enjoy a growing market in the next decade. These include high-efficiency boiler manufacturers and water treatment service providers.

Sectors that are overplayed

We think market expectations for solar and green car sectors are too high, and the reality may disappoint investors, for the following reasons.

Green cars

Another seemingly exciting opportunity for China to cut carbon emission is to switch to automobiles using non-fossil fuels (electricity or hybrid), or so-called "green cars". Road transportation accounts for 58% of China's transport sector's total CO2 emission. If regular gas-powered cars are upgraded to diesel, electric or hybrid cars, average CO2 emission

should halve. However, the biggest hurdle is the lack of commercially viable technologies. Currently, the cost of a green car is far from economically attractive to consumers. We estimate it will take eight to ten years for the fuel cost savings to cover the higher purchase price of a hybrid car. Toyota, the world leader in hybrid cars, has sold only 2m units in the past 10 years. BYD has so far sold 80 units in China.

Solar

In the global solar industry, China is a major producer with a 26% market share of solar modules and a 17% share of poly-silicon in 2009; Europe is the major consumer with Germany and Spain together accounting for 60% of global demand since 1998. Therefore, the most important factors that influence China's solar equipment producers are (1) world market demand; and (2) the over-supply situation in China. As for world demand, after a surge of 135% in 2008, new solar installation growth will likely be negative in 2009-2010.

Cost is the biggest hurdle. According to the EPIA (European Photo-Voltaic Industry Association), even in very sunny areas such as Bangkok and Los Angeles, it could take until 2030 for the unit cost of solar power to decrease to Euro0.07 and be competitive with other power sources. In addition, Deutsche Bank analyst Ivan Pan expects overcapacity will continue to haunt China's solar industry well into 2010. Solar module supply capacity in China increased 33% in 2009 while global demand dropped 5% in the same period. Solar energy is an attractive story, but its technology has not yet reached the point that would make the industry commercially attractive on a meaningful scale.

Investment implications

We believe the technology development and policy trend in China will be favorable to nuclear, wind and smart grids equipment manufacturers. However, we also believe that the market has underestimated the technology hurdles for green cars and the overcapacity risk facing the solar industry. In the following, we briefly discuss five companies that are representative of the above-mentioned sectors.

Dongfang Electric (1072.HK, Hold, HK$41.6) – nuclear, wind, IGCC

Among the three major power equipment suppliers, we believe Dongfang is best positioned to benefit from China's drive to build a low-carbon economy. According to Michael Tong, Deutsche Bank's power and equipment analyst, nearly all of Dongfang's 2011-12 revenue growth will be from the new energy markets. As of H1 2009, around 27% of its order backlog was from the nuclear sector and 12% from the wind sector. Among new orders in 1H09, nuclear and wind equipment together account for 61%. Therefore, its demand increase in the new energy sectors should largely offset the decline in demand for thermal power equipment in the next two years, but Dongfang's technology alliance with Royal Dutch Shell and orders from China's first few IGCC model projects have positioned it well to capture future opportunities. Michael Tong expects Dongfang to be the most counter-cyclical play in China's power equipment industry. The company is currently trading at 15.8x FY10E earnings, and Michael Tong expects it EPS growth to average 9% per annum in the next two years.

China High Speed (658.HK, Buy, HK$19.0) – wind equipment

China High Speed is the No.1 gearbox maker with a 43% share in a concentrated market with six domestic players. The company has secured orders until 2010 and management is guiding for 50% wind gearbox output growth in 2010. The company is also the only local gearbox exporters with a good track record of product quality. Deutsche Bank power and equipment analyst Michael Tong believes that the company has great potential to move into the global league through rapid and well-planned capacity expansion. Deutsche Bank has a Buy rating on the company. The company is trading at 18.0x 2010PE, with EPS growth estimated at 24% 2009-11 CAGR.

TBEA (600089.SH, NR, CNY23.8) – strong (high voltage) smart power grids

China plans to develop a clear blueprint for the smart power grid investments in the coming years. As the plan is rolled out, we expect power grid equipment manufacturers will be among the most important beneficiaries. TBEA is China's largest high-voltage transformer producer with around 30% market share in the State Grid's procurements in 2009. Located in Xinjiang Autonomous Region, the company also has the largest exposure among domestic peers to the Russian and Central Asia markets. According to Bloomberg consensus, the company is trading around 22x 2010E PE with a 2009-11E EPS CAGR of 25%.

BYD (1211.HK, Sell, HK$68.5) – green cars

We estimate the auto business represented over 80% of BYD's operating profits in FY09. Its share price has soared 520% over the past 12 months after the debut of its hybrid vehicle F3DM in December 2008. The impressive performance is partly owing to the c.120% yoy growth of auto sales, but, in our view, has also over-priced in the "green car" concept. According to Deutsche Bank auto analyst Vincent Ha, the current BYD share price implies that each BYD vehicle is worth three times the market cap per vehicle produced by other H share auto makers (see Figure 48). The number of F3DM cars sold, however, was below 100 by the end of Q3 2009. It is very difficult to justify how 100 green cars could make the 599,900 traditional cars three times more valuable. Vincent Ha believes that even with a potential local government subsidy (i.e. a subsidy of RMB30,000-50,000 per vehicle in Shenzhen as expected by BYD management), the price of the F3DM would still be at least 15% higher than the F3, which looks the same but is a gasoline-fuelled model. In addition, he expects the potential patent and safety tests to become challenges to the company's plan to export electric vehicles to the US from 2010. With 31.9x FY10E PE and 16% FY09-11 EPS growth, Deutsche Bank rates rating BYD a Sell.

Figure 48: Market cap per car of major H share automakers

	2010 mkt cap per car	Mkt cap as of Dec 8, 2009	2009 auto sales	2010 auto sales	2009 mkt cap per car
	US$/car	US$ mn	Unit th	Unit th	US$/car
BYD	**34.1**	20,489	429	600	47.8
Denway	**11.9**	4,889	359	410	13.6
Brilliance	**11.1**	1,543	237	139	6.5
Geely	**9.2**	3,664	308	400	11.9
Dongfeng Motor	**7.8**	12,962	1430	1660	9.1

Source: Bloomberg, Deutsche Bank

Suntech (STP.N, Sell, US$16.63)

According to Deutsche Bank solar sector analyst Ivan Pan, the Street as well as Chinese solar companies had very high expectations for domestic demand for solar panels since the government announced the first solar subsidy program – the BIPV subsidy – in April 2009. However, as we discuss above, solar power is too costly and technologically far from mature to meaningfully help China achieve its carbon reduction target. In particular, Ivan Pan expects Suntech – the largest Chinese solar panel manufacturer -- to recover at a slower pace than its peers due to its higher exposure to more expensive contracted polysilicon. He believes the current valuation has more than priced in the company's potentials such as the new Pluto technology and the company's scale advantage. Deutsche Bank has a Sell recommendation on Suntech.

Theme #5: Consolidation

- A major policy effort in 2010 is to force the reduction in excess capacity and encourage industrial consolidation. We believe this effort is a structural long-term positive for the key players – the consolidators -- in the raw materials sectors such as steel, cement, glass, and coal.
- The potential consolidators that we like are Angang for steel, CNBM for cement, Xinyi Glass for glass, and Shenhua and China Coal for coal.
- Underlying commodity prices as well as the equities themselves have high volatility and some of them also (including steel, cement, and glass) have substantial exposure to property and construction, which are subject to policy risks. Therefore, a buy-and-hold strategy is likely to bring substantial short-term volatility to an investor's portfolio. A potentially safer way to play the consolidation theme is to pair trade the Chinese consolidators against some regional peers that are no longer gaining substantial market shares.

Policy background

In September 2009, the State Council warned of overcapacity problem in six industries, namely, steel, cement, plate glass, coal chemicals, poly-silicon, and wind power equipment. Following that, several ministries promulgated a series of measures that promote consolidation in the six industries, restrict approvals for new projects, discourage lending to the six industries, and strengthen environmental oversight. The government will also develop a monitoring system for the six industries (including production, capacity, and environmental impact) and has asked local governments and the ministries to take responsibility for failing to enforce the measures.

The initial reaction by the market was negative as it had concerns that the sharp regulatory response implied the overcapacity problem was more serious than it had previously assumed. Also, by limiting new investments in these sectors, the measures will slow FAI growth in the manufacturing sector and negatively impact demand for some of the industries (such as cement and steel).

However, we believe that the government's efforts to limit new capacity and promote industry consolidation are a structural long-term positive for the key players – the consolidators -- in the respective industries. The sellers should also benefit but are often smaller private companies.

In addition to limiting new capacity, the government is also taking steps to eliminate existing capacity or simply shutting down small producers in many industries, such as coal mining, steel, and cement. For coal mining in particular, the government has significantly tightened the policy on small mines because of mining accidents that grab national news headlines.

The key issues for the consolidation theme are to 1) understand the magnitude and timing of the consolidation; 2) how to play this consolidation theme in a way that is relatively immune to the volatility of raw materials and commodity prices.

In the following sections, we analyze the magnitude of the government's capacity reduction efforts, estimate the potential for industrial consolidation, identify the most likely consolidators, and suggest a relatively safer way to play the benefit of consolidation. We focus on the steel, cement, glass and coal sectors since we believe the impact of the consolidation is meaningful to the industries and there are sufficiently large listed companies for investors.

Steel, Cement, Glass and Coal: four sectors benefiting from consolidation

Steel: building national champion and closing small steel mills

This section summarizes the analyses by Deutsche Bank raw materials analyst Julian Zhu.

According to NDRC and MIIT, the regulators aim to have the top five steel mills producing 45% of industry production and to reduce 72mt of crude steel capacity and 25mt of finished products capacity within three years, which is equivalent to c.3.5% of the capacity in China.

The target of the capacity reduction is polluting, smaller or inefficient steel mills. The regulators plan to shut down blast furnaces with less than 300 cubic meters capacity and electric arc furnaces with less than 20 tons of capacity by end-2011. Efficiency and environmental impact requirements will also be strictly enforced. Steel production must use less than 620kg of coal to produce 1m tons of steel. In December, MIIT said it will shut down all small steel mills (less than 1mtpa of crude steel capacity) that cannot meet environmental and energy consumption efficiency requirements.

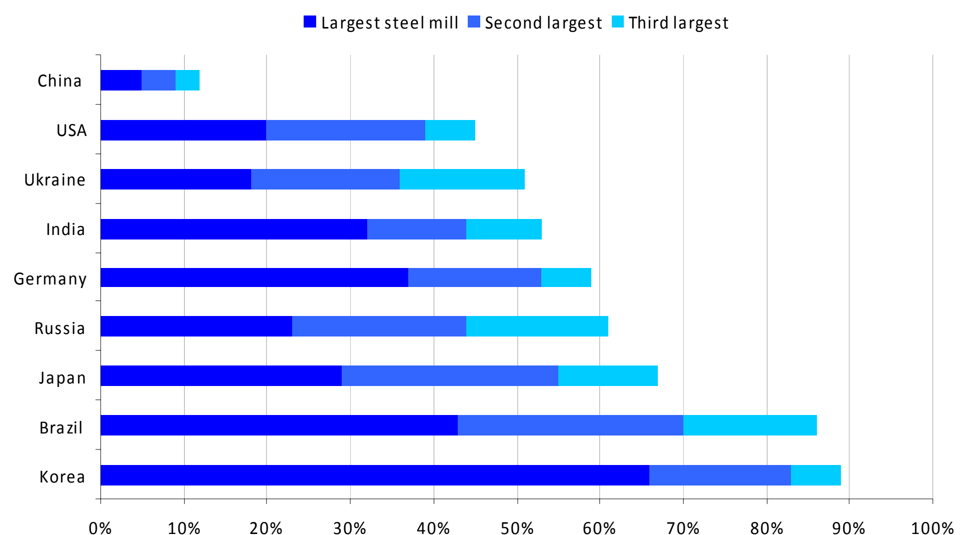
Figure 49: China steel industry M&A

Event	Announced year	Completed year	Period
Wuhan Steel acquiring Kunming Steel	2005	2007.8	2
Wuhan Steel acquiring Liuzhou Steel	2005	2008	3
Baoshan Steel acquiring Bayi Steel	2005.5	2007.1	2
Baoshan Steel reorganizing Guangzhou Steel & Shaoshan Steel	2004	2008	4
Establishing An-ben Steel Group	2005	n.a.	n.a.
Establishing Hebei Steel Group	2005	2008	3
Establishing Shandong Steel Group	2005-2006	2008	2

Source: Deutsche Bank, China Metallurgical News

The industry structure suggests room for further consolidation. Among the major steel producing countries, China steel production is the most fragmented with average capacity of less than 1mtpa crude steel. Moreover, China's top-five steel mills account for only 18.5% of steel production versus the global average of 55% and the government's target of 45%.

Figure 50: Global steel market structure, 2007



Source: Deutsche Bank, China Iron & Steel Association

Figure 51: China – latest steel industry policies

4-C Objectives	Quantified Targets for the Next Three Years	Supportive Policies
Closure of small-capacity and low-efficiency steel mills	Crude steel output and apparent consumption for 2009 set at 460mt (-8% y-o-y) and 430mt (-5% y-o-y) respectively	No new projects will be approved if the region does not achieve its quota for reducing capacity and pollution
	Crude steel output and apparent consumption for 2011 set at 500mt and 450mt respectively	Financial institutions are banned from financing enterprises that expand capacity or relocate low-efficiency equipment without approval. No land use rights will be granted to those companies
	Cut down crude steel capacity by 72mt and finished products capacity by 25mt within 3 years	To close furnaces with capacity below 300 cubic meters and oxygen converters and electric arcs with capacity below 20t
		Earmarking funds in the government budget to support steel mills' technological renovation and innovation in the form of interest rate subsidies
Consolidation and relocation	The top 5 steel mills to account for 45% of China's total capacity	Large state-owned steel mills will be given preferential access to domestic iron ore mines with reserves over 50mt
	Steel enterprises in the coastal regions to account for over 40% of China's total capacity	The government is ready to give interest rate subsidies to large "pillar enterprises"
	Baogang Group, Anshan-Benxi Steel Group and Wugang Group to increase capacity to over 50mt by 2011	
	Several steel companies to have capacity of 10-30mt	
Coordinated downstream demand	Construction sector to contribute 50% of China's total steel consumption	Stabilizing and expanding the demand from downstream sectors including autos, shipbuilding, equipment manufacturing etc. by implementing rejuvenation plans for the respective industries
		Ensuring the demand from government housing projects, rural area construction projects, post-earthquake reconstruction, and infrastructure projects such as highways, railways and airports
Cross-border acquisition of upstream companies		Large steel enterprises are encouraged to acquire iron ore mines overseas
		The government provides support with various forms of financing steel mills' overseas acquisitions, such as stock offering, debt, private equity, etc.

Source: Deutsche Bank, State Council of China

This market fragmentation, combined with the government's strong push towards consolidation, suggests we could see many large mergers in the Chinese steel industry in the next few years.

We expect to see significant consolidation in the China steel industry in 2009-11, shaking up the overly-fragmented steel industry. In our view, companies with robust balance sheets or strong government support (meaning good access to bank loans) are likely to expand their capacity and market share aggressively. Meanwhile, companies with weak balance sheets that are expanding too fast at the current cycle peak will either be acquired or closed, in our view.

We expect the top players in China, including Angang and Baogang, to continue their consolidation strategy by acquiring other steel mills thereby expanding capacity and gaining market share. Furthermore, with the favorable government policy support, we expect both Angang and Baogang to be able to buy good assets at prices that will add value to the two companies.

Cement: bigger companies getting bigger

Consolidation and phasing out capacity with an obsolete production method (vertical kiln) has been ongoing for the cement industry. We believe the current policy will accelerate the pace of consolidation and capacity shutdown.

The NDRC is aiming to shut down an additional 500mtpa of vertical kiln cement capacity in 2010-2012 (c.30% of 2008 industry capacity) in contrast to the 284mtpa target for 2006-2010. The NDRC has also suspended construction starts for all new cement capacity for one year and has put in place tougher environmental and efficiency requirements for new capacity, such as fuel efficiency and pollution discharges.

Cement makers that want to add new capacity must shut down an equal amount of vertical kiln capacity in provinces that have excessive vertical kiln capacity. This policy should quicken consolidation as cement makers that want to grow will need to buy out smaller competitors.

Despite the consolidation of the past few years, cement remains a highly fragmented industry. Production from the top fifteen cement makers increased to 25% in 2008 from 21% in 2006, suggesting there is still significant room for further consolidation as there are c.5,000 cement producers in China. The pace of consolidation should pick up in the next three years because of the NDRC's aggressive shutdown target. The new target is 75% higher than the previous one, and is required to be achieved one year earlier.

On the back of a policy supportive of industry consolidation, we believe large cement producers will remain the acquirers in the industry. We believe CNBM and Anhui Conch are well-placed to acquire capacity given they benefit from supportive policies for large producers (e.g. tax breaks). TCC International, 44% owned by Taiwan Cement, is also adding to cement production capacity in China (existing: c.11mtpa). The company has announced it will acquire cement production assets from Prosperity International Holdings, which has existing production capacity of 9.6mtpa and capacity under construction of 5.5mtpa.

Figure 52: Top 15 China cement makers (2008)

	cement production (mt)	Market share
Anhui Conch	81.4	6%
CNBM	66.2	5%
South Cement	39.6	3%
China United	26.6	2%
Shanshui Cement	26.5	2%
Huaxin Cement	25.2	2%
Jidong Cement	17.9	1%
Sinoma	17.5	1%
Larfage	17.2	1%
CR Cement	14.1	1%
Yatai Cement	13.9	1%
Tianrui Cement	13.3	1%
BBMG	12.9	1%
Zhejiang Hongshi Cement	11.1	1%
Jinfeng Cement	10.2	1%
Asia Cement	10.1	1%
Taiwan Cement	9.6	1%

Source: Deutsche Bank, China Cement Association

Flat glass: consolidation needed to achieve government target

The Ministry of Information and Industrial Technology (MIIT)'s target for the flat glass industry is that the top ten producers should account for 70% of China's glass production by 2012. Currently, the top 10 glass producers accounted for only 43% of production with the largest maker accounting for 10% of production. The regulators also aim to phase out the older horizontal sheet process capacity. Moreover, the government is supportive of industry consolidation and production with newer technologies, such as those for display glass and solar-panel glass.

We believe there is scope for consolidation in the industry given that the current industry concentration is far from MIIT's target. We believe Xinyi Glass (0868.HK, NR, HKD7.0) will be one of the beneficiaries of the consolidation trend. Xinyi Glass is a large glass maker in China. It is among the top three in ultra clear passenger vehicle glass and one of the largest auto glass exporters in China. Its solar glass (ultra-clear photovoltaic glass) is a beneficiary of the government's policy to promote newer technologies in the industry.

Coal: small mines policy to expand to other provinces

The problem for the coal mining industry is mine accidents at small mines rather than overcapacity. Small mines are structurally prone to accidents due to low mechanization rate and aggressive operations. In Shanxi, the problem is even greater as it is an older mining area with many small mines and a lot of these small mines are owned by investors with a mindset focused on turning a quick profit.

After a series of headline grabbing accidents, Shanxi province pushed out an aggressive campaign against small mines. While NDRC policy targets mines with production of less than 300ktpa, the Shanxi government raised the minimum production to 900ktpa. It also shut down production at some small mines and required some of them to be consolidated.

We believe the small mines policy will gradually be phased into other provinces in the future. Officials from other provinces, such as Inner Mongolia and Henan, recently visited Shanxi to study the policy roll-out in Shanxi. We also expect small mines accidents to persist, pressuring the government to maintain the policy intensity on small mines.

Figure 53: Shanxi small mines policy

Date	Details
2006	Procedures of Shanxi Province for Redisposing, Coordinating and Paid Utilizing of Coal Resource - Reorganize & close mines with production less than 90ktpa with focus on sub-300ktpa mines
August 2008	Implementation opinion to speed up coal enterprise M&A - Require 300ktpa minimum production for each mine shaft - Reduce number of mines to less than 1,500 & large mining group to operate over 75% of output by 2010
April 2009	The plan to adjust and revitalize Shanxi coal enterprise - Reduce mine shafts from 2,598 to 1,000 by 2011 and to 800 by 2015 - Require 3mtpa minimum production for each coal enterprise and 900ktpa min. prod. for each mine shaft

Source: SX Coal, CCTD, Deutsche Bank

The coal mining industry is fairly fragmented with the top ten producers accounting for 32% of production in 2008. The industry also has a high proportion of production from smaller companies. Township and village enterprise ("TVE", a proxy for small mines) accounted for 38% of production in 2008. With low industry concentration and significant production from smaller mining companies, we expect the pace of consolidation to continue.

We expect large coal companies in Shanxi to lead the consolidation process in the province. The province's official plan is to reduce the number of mining enterprises in Shanxi from 2,200 to 130. The five large provincial SOEs (Shanxi Datong, Shanxi Coking, Lu'an, Jincheng, and Yangquan) should get the best assets, but we also believe China Coal Energy will be able to acquire good assets, especially in Pingshuo where it is the designated consolidator.

We believe the small mines policy will eventually be rolled out into other provinces. When the small mines policy is implemented in areas where Shenhua operates (Shaanxi and Inner Mongolia), Shenhua should be able to add quality assets as well given it is one of the largest miners in the two provinces.

Figure 54: Top 10 coal producers in China (2008)

Company	ROM production (mn ton)	Market share
Shenhua Group	281.3	11%
China Coal Group	114.1	4%
Shanxi Coking Coal	80.3	3%
Shanxi Datong	68.9	3%
Shaanxi Coal and Chemical	60.4	2%
Anhui Huainan	56.7	2%
Longmay Mining	55.0	2%
Henan Coal and Chemical	44.7	2%
Lu'an Group	42.1	2%
Pingdingshan	41.2	2%

Source: Deutsche Bank, China Coal Industry Assoc

How to play consolidation

We believe consolidation and capacity reduction will be a multi-year trend in the above-mentioned raw materials sectors. The industries' supply-demand balance should improve over time as capacity is reduced and industry concentration increases. The consolidators that we like are Angang for steel, CNBM for cement, Xinyi Glass for glass, and Shenhua and China Coal for coal.

The underlying commodity prices as well as the equities themselves have high volatility and some of them also (including steel, cement, and glass) have substantial exposure to property and construction which are subject to policy risks. Therefore, a buy-and-hold strategy will bring substantial short-term volatility to an investor's portfolio. A safer way to play the consolidation theme is to pair trade the Chinese consolidators against some regional peers that are no longer gaining substantial market shares.

We believe the same industries in other countries have seen consolidation played out, such as steel and cement in Taiwan and cement in India, or have higher industry concentration.

Taiwan's cement industry has high concentration and has significant export exposure (e.g. Nigeria, Middle East, and South East Asia), and India's top five cement makers have combined market share of over 60%. We like Asia Cement (1102.TW, Hold, TWD34.6) less than Taiwan Cement (1101.TW, Hold, TWD34.0), and rate India Cements (ICMN.BO, Sell, INR123.4) a Sell. Moreover, we believe Asia Cement China (0743.HK, NR, HKD4.7) could also be a hedge as the cement market fundamental in Southwest China is poor.

Taiwan's steel industry also has high concentration, but its export exposure means it also benefits from the changes in China although the impact should be less than at domestic Chinese steel mills. China Steel is the largest steel company in Taiwan. In Korea, the steel industry is dominated by three large players (POSCO (005490.KS, Buy, KRW618,000), Hyundai Steel (004020.KS, Buy, KRW86,500) and Dongkuk Steel (001230.KS, Sell, KRW27,000)). We rate Dongkuk Steel a Sell.

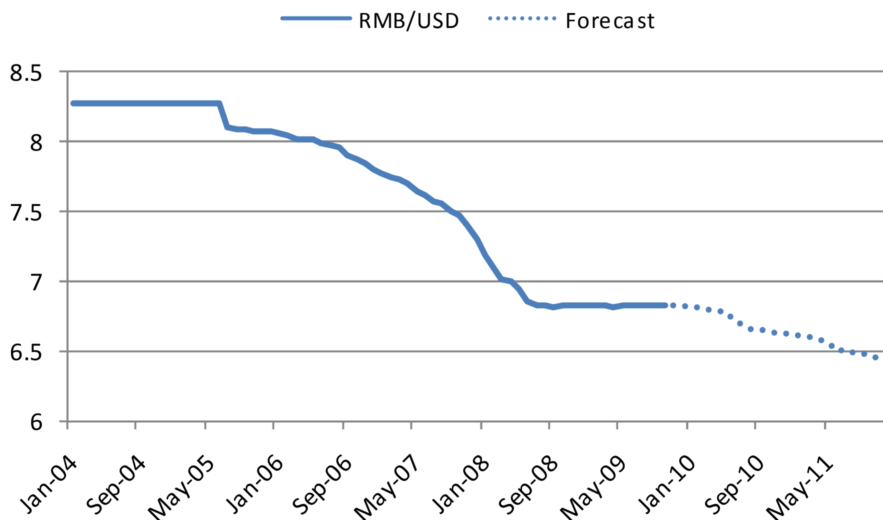
Theme #6: RMB appreciation

- We expect the RMB to resume appreciation vs. the USD from March-April of 2010 at an annualized rate of 4-5%. Within the next 10 years, we believe the RMB will appreciate by a cumulative 50%.
- We provide updated estimates of the earnings impact of RMB appreciation on major sectors. The major beneficiaries include airline, steel, paper, auto, and HK/Macau tourism, while the losers include oil, nonferrous metals, and exporters.

The RMB should resume its appreciation in H1 2010

China has maintained a de facto peg of the RMB to the USD since July 2008, after allowing it to appreciate 21% in the previous three years. The de facto "re-pegging" primarily reflected the government's concerns regarding the sharp decline in exports and the resulting layoff of millions of migrant workers during the global crisis. We expect the RMB to resume its appreciation trend at annualized pace of about 4% starting from late Q1 or Q2 in 2010.

Figure 55: RMB appreciation



Source: Deutsche Bank, CEIC

In our view, the resumption of RMB appreciation is a high probability event in 2010 for the following reasons: 1) we estimate that by Q2 2010, yoy export growth will reach 15-20%, more than enough to eliminate the previous policy concerns regarding unemployment due to the export slump. 2) Emerging market economies will likely join G3 in complaining about Chinese RMB depreciation against their currencies. Over the past eight months, the RMB has depreciated 10-30% against major emerging market currencies such as the Korean Won, Mexican Peso, Brazilian Real, and South African Rand. As China is keen to keep its image as a responsible nation especially within the EM economies, pressure from these countries is likely to be constructive in influencing China's exchange rate policy. 3) By the first half of 2010, China should be beginning to experience some imported inflation for example in oil, soft commodities, and mining products. RMB appreciation could help offset part of the imported inflation.

The RMB will likely appreciate 50% in 10 years

In terms of pace RMB appreciation, we believe the appreciation pace could be as fast as 5-7% (annualized) in the initial one or two months to demonstrate China's willingness to play a "responsible role", but will later stabilize around 3% towards the end of 2010 as export growth decelerates on a mild "second dip" of the US economy. Our medium-term forecasts of the RMB exchange rate is shown in Figure 56.

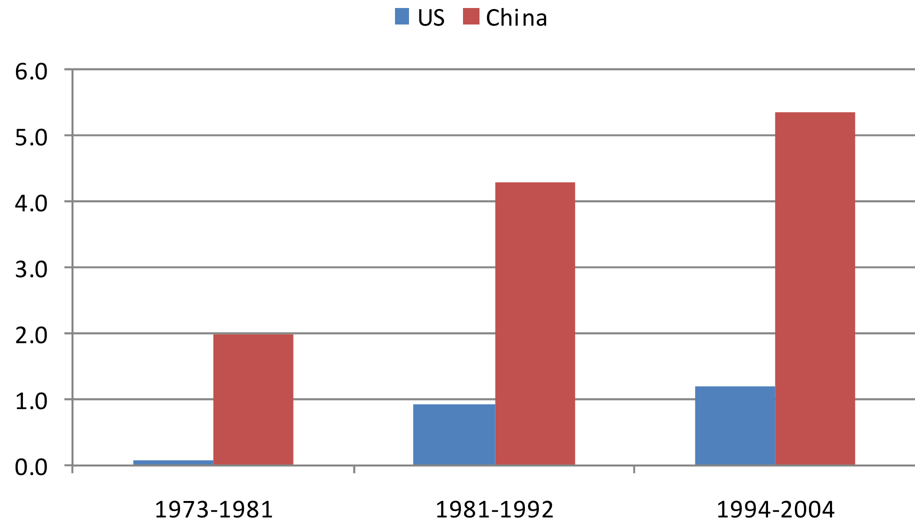
Figure 56: USD/RMB exchange rate forecast

	1Q10	2Q10	3Q10	4Q10	2011	2012
DB	6.80	6.73	6.65	6.64	6.38	6.15

Source: Deutsche Bank

In the longer term, a 4% annual average appreciation of the RMB against the USD is justified by China's strong productivity growth. The following chart (Figure 57) shows that China's total factor productivity growth is about 5ppt faster than that of the US. This should allow China to cut its USD prices of export products even with annual currency appreciation of 4%. In addition, the desire of the Chinese authorities to internationalize the RMB – namely to achieve convertibility in probably ten years' time and eventually for the RMB to become an international reserve currency – should provide psychological support for the RMB. That is, before currency convertibility is finally achieved policies will likely support a gradual appreciation of the RMB in order to establish its credibility as an attractive reserve currency. For these reasons, we therefore expect the RMB to appreciate cumulatively by 50% vs. the USD within the next ten years.

Figure 57: Total productivity factor growth (annual average), China vs. US



Source: Deutsche Bank, ECB, JPEC, UN

Impact on sectors

In May 2005, two months before China's decision to move towards a managed floating exchange rate system, we published a report on *18 Ways to Play the RMB*. That report uses a CGE model to estimate the impact of RMB appreciation on all major sectors. Qualitatively most of the conclusions of that report remain valid. Investors who are interested in details should refer to that report. In the following we discuss the sectoral impact of RMB based on our analysts bottoms-up estimates using the latest company level data.

There are two main channels via which RMB appreciation affects companies' financials:

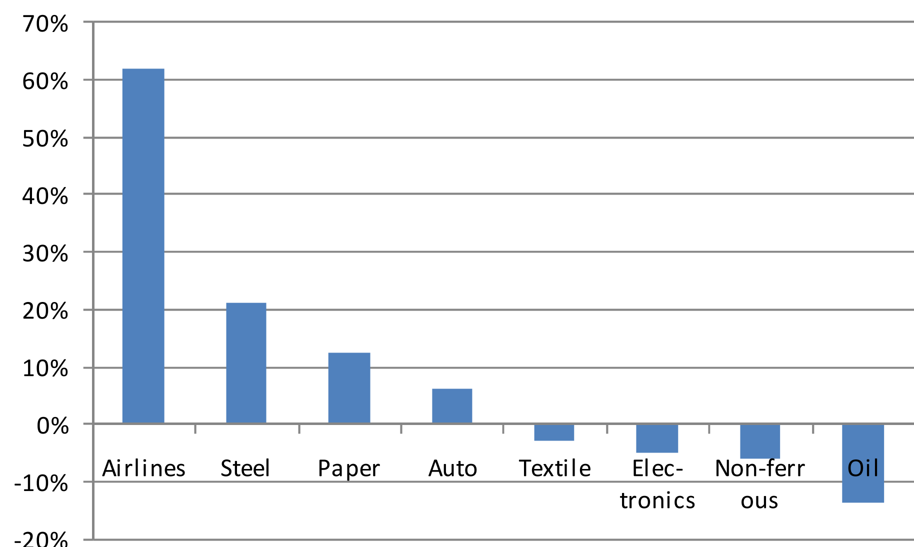
First, RMB appreciation enhances (reduces) the earnings of companies with USD (RMB) dominated costs and RMB (USD) denominated revenues. For example, most exporters, including textiles and electronics producers, suffer from RMB appreciation because of their USD-denominated revenues. Oil and non-ferrous metal producers are also victims because the pricing of their products is in USD. On the other hand, steel, paper, and auto makers benefit from RMB appreciation because they import raw materials and components that are denominated in USD.

Second, RMB appreciation reduces the debt-service burden on companies that are exposed to foreign currency debt. The most typical examples are Chinese airlines.

In Figure 58 we summarize our analysts' estimates of the impact on major listed companies' average 2010 earnings assuming RMB appreciation of 3%, relative to a scenario of no RMB appreciation. We detail the reasons behind EPS impact and the most sensitive names within each sector the next section.

Other than these direct P&L implications, a few other sectors are affected in a number of different ways, the impact of which is difficult to quantify. These include (1) Chinese real estate: with RMB appreciation, China properties should become a more attractive asset play for dollar investors; (2) Hong Kong retail and Macau gaming: the purchasing power of Chinese visitors to Hong Kong and Macao should rise as a result of RMB appreciation.

Figure 58: Impact of 3% RMB appreciation 2010 on sector EPS



Source: Deutsche Bank
Note: Sector EPS impact is calculated as simple average of Deutsche Bank-covered companies' EPS impact.

Potential Beneficiaries

Airlines

The benefit of RMB appreciation for the airline industry is substantial due to their very high external debt exposure and very low profits to start with. A stronger RMB would substantially reduce the debt service costs of most carriers as USD-dominated debts account for around 70% of their total liabilities. The airlines could also save part of their fuel costs for international flights due to RMB appreciation as oil products are priced in USD terms.

According to the sensitivity analysis by Deutsche Bank transportation sector analyst Vincent Ha, the impact of a 3% RMB appreciation in 2010 would enhance FY10 as-reported EPS by 95% for China Eastern, 51% for China Southern and 39% for Air China. In addition, it will

boost their FY10 book values (and thus reduce FY10 PB ratios) by 29%, 7% and 5%, respectively. China Eastern is the most leveraged among the three major carriers due to its lowest net margin and highest debt/equity ratio.

Steel

The steel sector imported 470m tons of iron ore in the first three quarters in 2009. This represents 35% yoy growth and a significant increase in import reliance to over 70% in 1H09 from about 50% during the previous six years. A stronger RMB is good news for the sector in the long run because the high-quality imported ores only become a more important part of its cost structure due to depletion of domestic iron ore reserves.

Meanwhile, due to weak foreign demand, the exports of Chinese steel products accounted for only 3.1% in Jan-Sep 2009, much lower than 9-11% during 2006-08. In this regard, RMB appreciation has only limited negative impact on the RMB value of the export proceeds.

Assuming that in 2010, 1) iron ores represent 40% of steel companies' revenue, 2) steel exports accounts for 5% of total sales (3.1% in Jan-Sep 2009 and 9-11% during 2006-2008), and 3) the industry's net margin is 5% (broadly in line with the 2001-08 average but higher than that in 2009), an RMB appreciation of 3% would enhance the industry's net profits by around 23%. For companies with small profit margins and lower exports, the benefit would be even greater.

At the company level, we estimate the benefit would be around 25% of FY10E EPS for Baogang and Maanshan Steel, and 13% for Angang. The smaller benefit for Angang is because of the company's higher export exposure (15-20% vs. c.10% for Baosteel and c.5% for Maanshan Steel) as well as its higher profit margin.

Paper

The paper industry imports around 70% pulp and recycled paper as inputs. On the other hand, exports account for only about 5% of sector sales. According to Deutsche Bank paper sector analyst Karen Tang, an RMB appreciation of 3% would boost the FY10E EPS of Nine Dragon and Lee & Man by 10-15% given their ~30% export exposure.

Auto

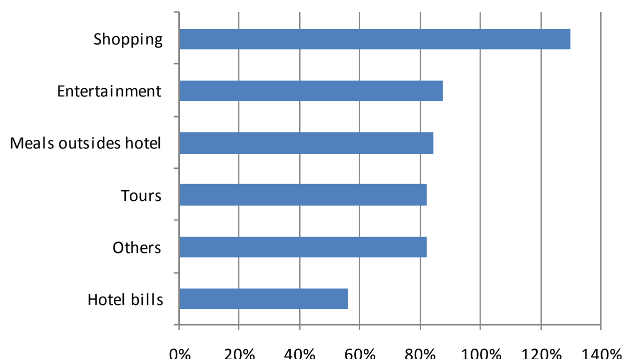
Auto parts and components account for 70-80% of the total COGS of Chinese auto makers. According to Deutsche Bank auto analyst Vincent Ha, imported parts account for about 20% of the component costs for JV brands. Their import reliance is about 10 ppts lower than the level five years ago due to localization and increased relocation of foreign production bases to China. We estimate, the benefit of a 3% RMB appreciation (vs. the USD) would be an enhancement of around 5% to 2010E EPS for the auto sector. Vincent Ha believes the most obvious beneficiary under Deutsche Bank coverage would be Brilliance (1114.HK, Hold, HK$2.19). In its JV (which contributes around two-thirds of Brilliance's total profits) with BMW, the EUR-denominated imported parts account for 55% of its component costs. Deutsche Bank expects 3% USD appreciation against the EUR so the benefit of RMB appreciation would be around 15% of its FY10E EPS.

Hong Kong tourism and Macau gaming

Mainland tourists now account for 61% of all visitors to Hong Kong and 50% to Macau. On a per capita basis, they spend more than foreign tourists -- per capita Chinese spending is about 137% above average visitor spending in Macau and 4% above average in Hong Kong. The stronger purchasing power of Chinese visitors due to rising RMB appreciation (vs. the USD and thus the HKD) should provide a meaningful benefit to Hong Kong retail brands and Macau casinos (see Figure 59 and Figure 60). In the Hong Kong consumer universe, Lifestyle (Buy, HK$14.46) and Sa Sa International both generate around 40% revenue from mainland visitors. For Macau casinos, Deutsche Bank gaming & tourism analyst Karen Tang estimates

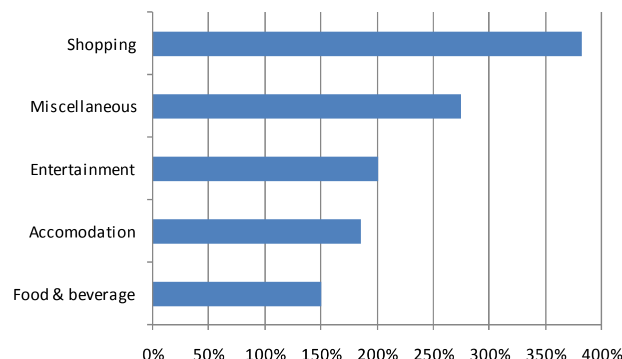
75% revenue is from mainland players. Her top pick is SJM (0880.HK, Buy, HK$4.3), which is the largest operator with 27% market share in 3Q09 and its Oceanus will likely be the only large-scale casino opening in 2010.

Figure 59: Per capita spending Chinese visitors in Hong Kong as % of visitor average, 2008



Source: Deutsche Bank, CEIC

Figure 60: Per capita spending of Chinese visitors in Macau as % of visitor average, H1 2009



Source: Deutsche Bank, CEIC

High-end real estate

The RMB appreciation will have no direct impact on property developers' financials. However, it will likely attract more speculative capital inflows from aboard into the high-end real estate market in China. In Tier-1 cities like Beijing, Shanghai and Shenzhen, the purchases by foreign and Hong Kong/Taiwan investors account for 10-30% of the high-end properties in recent years, according to estimates of the local property market research company Fangfang Consultant. RMB appreciation would further increase the attractiveness of such properties for dollar investors.

Potential Losers

Oil

The pricing of oil prices is USD based, and therefore crude producers' revenues will decline in RMB terms if the RMB appreciates vs. the USD. On the other hand, the costs of production are largely denominated in the RMB. Assuming a 3% RMB appreciation, Deutsche Bank oil analyst David Hurd estimates that the impact on FY10 EPS will be -18% for PetroChina, -15% for Sinopec, and -7.8% for CNOOC.

David Hurd's calculation is based on his estimates that revenue exposure to the USD is 90%, 95% and 100% for Sinopec, PetroChina and CNOOC. The cost exposure (i.e., to imported crude oil) for the three oil majors is 50%, 5% and 15%, respectively.

Non-ferrous metals

Major non-ferrous names such as Chalco, and Jiangxi Copper all have their product selling prices linked to USD-denominated global commodity prices. Deutsche Bank sector analyst Julian Zhu estimates that a 3% RMB appreciation reduces FY10 earnings by 4% for Jiangxi Copper, and 9% for Chalco. The calculation has already taken into account the lower input costs on cheaper imported copper concentrates (c.30% for Jiangxi Copper) and bauxite (c.20 for Chalco) due to RMB appreciation.

Electronics and textile/apparel exporters

Electronics and textile/apparel exporters suffer from RMB appreciation mainly via translation losses. Nevertheless, we believe the strong recovery of overseas demand in 2010 will lend Chinese exporters increased pricing power. The volume and ASP recovery of the export sectors should much more than offset the negative impact of RMB translation loss.

The following estimates focus only on the translation gains/losses. According to Deutsche Bank telecoms/technology sector analyst Alan Hellawell, the net impact of 3% RMB appreciation on 2010E EPS is a positive 3% to Lenovo because its COGS are largely in USD while around 50% revenue are in RMB. BYD Electronics and ZTE both have the majority of their costs in RMB and a significant portion of sales in USD (around 50% for ZTE and 45% for BYD Electronic). For a 3% RMB appreciation in 2010, Alan Hellawell estimates the direct translation loss to be 3-5% of their FY10E EPS.

In the textile & garment universe, Deutsche Bank sector analyst Anne Ling estimates that a 3% RMB appreciation will result in a 4% decline in FY10 EPS via translation loss. The impacts on other names in the sector such as Esprit and Li & Fung are smaller.

Appendix A: Deutsche Bank China universe

Figure 61: Deutsche Bank China universe (Buy recommendations)

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	Beta	P/E (DB EPS) (x)		P/BV (x)		EPS Growth(%)	
							2009	2010	2009	2010	2009	2010
Alibaba.com Limited	1688.HK	Software & Services	Buy	18.00	11,709	1.10	80.4	48.5	16.2	12.6	-13.6	65.8
Angang Steel	0347.HK	Materials	Buy	17.12	15,974	1.68	52.6	14.6	1.9	1.9	-30.8	261.8
Anhui Conch Cement-H	0914.HK	Materials	Buy	49.90	11,366	1.25	20.4	13.4	2.7	2.3	46.1	52.3
Anta	2020.HK	Consumer Durables & A	Buy	11.52	3,699	1.04	22.5	18.9	5.1	4.6	19.1	19.0
Bank of China	3988.HK	Banks	Buy	4.20	137,469	0.89	12.1	10.4	1.9	1.7	19.1	15.9
Bank of Communications	3328.HK	Banks	Buy	9.01	56,920	1.31	13.9	10.3	2.3	1.9	-0.8	35.4
Beijing Cap Int'l Airport	0694.HK	Transportation	Buy	5.14	2,870	1.35	70.7	31.5	1.5	1.5	215.5	124.2
Chalco	2600.HK	Materials	Buy	8.55	14,910	1.67	-44.3	17.8	1.9	1.7	NM	NM
China CITIC Bank	0998.HK	Banks	Buy	6.63	33,369	1.09	14.6	10.7	2.2	1.9	16.9	36.1
China Coal Energy	1898.HK	Energy	Buy	14.24	24,345	1.88	19.4	15.1	2.6	2.3	-0.7	28.6
China Comm Services	0552.HK	Telecommunication Serv	Buy	3.82	2,843	0.97	11.7	10.7	1.4	1.3	23.9	9.9
China Construction Bank	0939.HK	Banks	Buy	6.67	200,985	1.22	12.9	11.4	2.6	2.2	15.0	13.0
China Dongxiang	3818.HK	Consumer Durables & A	Buy	6.00	4,383	0.86	20.7	17.7	4.1	3.8	19.0	16.5
China Foods	0506.HK	Food, Beverage & Tobac	Buy	6.96	2,505	0.74	29.0	22.8	3.6	3.3	37.5	27.3
China High Speed Trans	0658.HK	Capital Goods	Buy	18.96	3,302	1.45	23.5	18.0	4.6	3.8	38.2	31.2
China Life Insurance	2628.HK	Insurance	Buy	38.35	139,768	1.03	34.6	30.4	4.0	3.5	29.6	13.8
China Mengniu Dairy	2319.HK	Food, Beverage & Tobac	Buy	27.75	5,851	0.99	31.2	27.5	5.2	4.5	NM	13.4
China Merchants	0144.HK	Transportation	Buy	25.25	7,890	1.50	21.8	18.8	1.9	1.9	-8.1	15.8
China Merchants Bank-H	3968.HK	Banks	Buy	20.35	46,889	1.32	17.1	15.0	3.2	2.7	-26.5	14.5
China Railway Constr.	1186.HK	Capital Goods	Buy	9.95	15,829	0.65	20.5	13.8	2.1	1.9	52.7	48.0
China Railway Group	0390.HK	Capital Goods	Buy	6.04	16,589	0.96	18.5	13.5	1.9	1.7	11.8	36.8
China Resources Power	0836.HK	Utilities	Buy	15.44	8,871	0.74	13.6	13.6	1.9	1.7	184.0	0.4
China Shenhua Energy	1088.HK	Energy	Buy	38.00	97,458	1.51	20.1	16.3	3.9	3.3	24.5	23.3
China South Locomotive	1766.HK	Capital Goods	Buy	5.70	8,702	NA	34.5	25.1	3.3	3.0	24.5	37.1
China Vanke - B shares	200002.SZ	Real Estate	Buy	9.73	13,795	1.14	16.7	14.0	2.5	2.2	14.3	19.5
China VTM Mining	0893.HK	Materials	Buy	5.08	1,045	NA	27.6	16.9	3.3	2.9	-2.3	62.9
China Yangtze Power	600900.SS	Utilities	Buy	13.36	19,207	0.83	26.9	19.3	2.3	2.2	13.7	39.3
CNBM	3323.HK	Materials	Buy	16.06	5,405	2.00	14.4	7.8	4.0	3.6	51.6	84.5
Ctrip.com International Ltd	CTRP.OQ	Consumer Services	Buy	73.00	4,912	1.35	55.3	40.0	14.4	11.5	39.7	38.2
Dongfeng Motor	0489.HK	Automobiles & Compone	Buy	11.18	12,421	1.25	13.6	11.6	3.2	2.6	53.7	17.7
Focus Media	FMCN.OQ	Media	Buy	15.48	1,995	1.75	76.3	22.3	1.7	1.5	NM	241.3
Franshion Properties	0817.HK	Real Estate	Buy	2.74	3,155	1.08	21.8	16.3	2.1	1.9	-7.2	34.0
Global Bio-Chem	0809.HK	Food, Beverage & Tobac	Buy	1.91	571	1.15	19.9	6.7	0.6	0.5	-64.2	198.0
Glorious Property	0845.HK	Real Estate	Buy	3.51	3,102	NA	14.1	8.2	1.9	1.6	103.7	72.0
Golden Eagle Retail	3308.HK	Retailing	Buy	15.84	3,725	0.66	33.7	27.8	9.6	8.2	30.5	21.4
Gome	0493.HK	Retailing	Buy	2.82	5,474	0.82	31.0	22.3	3.3	3.0	-33.2	38.7
Guangdong Investment	0270.HK	Utilities	Buy	4.53	3,616	0.57	13.6	12.6	1.7	1.6	8.9	7.8
Hengan Intl.	1044.HK	Household & Personal Pr	Buy	57.60	9,056	0.54	34.2	27.7	8.7	7.9	53.0	23.6
Huabao Int'l	0336.HK	Materials	Buy	8.37	3,333	0.39	16.8	19.9	7.7	7.6	29.3	20.0
ICBC	1398.HK	Banks	Buy	6.44	277,368	1.09	14.5	13.3	2.8	2.5	19.2	8.6
Lee & Man Paper	2314.HK	Materials	Buy	5.30	777	1.57	6.5	4.9	0.1	0.6	-79.8	273.9
Lianhua Supermarket	0980.HK	Food & Staples Retailing	Buy	23.40	1,877	0.45	25.5	20.8	4.8	4.2	22.1	22.1
Maanshan-H	0323.HK	Materials	Buy	5.68	5,654	1.56	42.3	12.8	1.4	1.3	28.5	229.4
New World Dept Store China	0825.HK	Retailing	Buy	7.11	1,546	1.11	13.6	18.6	2.3	2.6	13.5	17.6
Nine Dragons Paper	2689.HK	Capital Goods	Buy	12.50	7,288	2.05	13.9	21.3	1.3	2.6	-39.0	136.6
Ping An Insurance Grp	2318.HK	Insurance	Buy	68.00	65,713	1.26	38.3	26.1	3.9	3.5	4,179.7	46.6
Ports Design Limited	0589.HK	Consumer Durables & A	Buy	24.10	1,736	1.21	24.8	20.2	8.0	7.2	16.0	22.9
Shanghai Forte Land	2337.HK	Real Estate	Buy	2.54	828	1.00	13.9	9.6	1.0	0.9	15.8	44.4
Sina Corp	SINA.OQ	Software & Services	Buy	45.22	2,463	1.23	45.0	28.5	2.9	2.8	-24.7	57.8
Sinofert Holdings Ltd	0297.HK	Materials	Buy	4.34	3,908	0.96	-50.8	23.0	2.0	1.8	NM	NM
Sinoma	1893.HK	Capital Goods	Buy	5.77	2,656	1.10	17.1	11.4	2.4	2.1	32.3	49.5
Sinopec-H	0386.HK	Energy	Buy	6.91	77,252	1.09	9.1	8.3	1.4	1.3	95.6	9.3
Tencent	0700.HK	Software & Services	Buy	168.50	39,134	1.07	52.9	34.7	23.3	14.7	85.2	52.2
Weichai Power	2338.HK	Capital Goods	Buy	62.70	6,735	1.11	15.2	13.5	4.2	3.2	57.2	12.5
Zhejiang Expressway Ltd	0576.HK	Transportation	Buy	7.19	4,027	0.78	16.5	13.4	1.9	1.8	-11.8	22.4

Source: Deutsche Bank Note: details of coverage, ratings and target prices may be found on http://gm.db.com

Figure 62: Deutsche Bank China universe (Hold and Sell recommendations)

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	Beta	P/E (DB EPS) (x)		P/BV (x)		EPS Growth(%)	
							2009	2010	2009	2010	2009	2010
Air China	0753.HK	Transportation	Hold	6.07	9,589	1.31	610.2	19.3	2.8	2.4	NM	3,065.5
Baidu	BIDU.OQ	Software & Services	Hold	416.23	14,400	1.20	68.2	44.8	21.7	14.6	38.0	52.3
Beijing Enterprises	0392.HK	Capital Goods	Hold	56.25	8,247	0.58	27.0	22.9	2.0	1.9	17.7	18.0
Belle International Holdings Ltd	1880.HK	Retailing	Hold	9.06	9,853	1.19	27.2	22.4	4.5	3.9	23.7	21.6
Brilliance China	1114.HK	Automobiles & Components	Hold	2.19	1,253	1.08	-11.9	17.4	1.6	1.6	-10,458.4	NM
Byd Electronic	0285.HK	Technology Hardware & Equ	Hold	6.35	1,846	0.82	20.7	16.7	2.0	1.7	-42.1	24.1
China Comm. Constr.	1800.HK	Capital Goods	Hold	7.43	14,203	1.35	13.1	11.2	2.1	1.8	24.2	17.7
China Everbright Int'l	0257.HK	Commercial Services & Supp	Hold	4.00	1,697	1.10	33.8	29.9	3.1	2.9	45.1	12.7
China Gas Holdings	0384.HK	Utilities	Hold	4.24	1,825	0.95	18.5	29.9	1.3	3.9	136.8	73.4
China Minsheng Bank	600016.SS	Banks	Hold	7.91	23,738	1.11	13.0	12.0	1.9	1.7	30.5	8.5
China Mobile	0941.HK	Telecommunication Services	Hold	72.85	188,283	0.93	11.3	11.2	2.5	2.2	0.4	0.9
China Molybdenum	3993.HK	Materials	Hold	6.24	3,923	1.71	40.7	20.6	2.5	2.4	-59.9	97.2
China Oilfield Services	2883.HK	Energy	Hold	9.30	5,392	1.68	11.9	10.0	1.7	1.1	-2.9	19.0
China Power Int'l	2380.HK	Utilities	Hold	1.95	999	0.81	17.4	12.3	0.8	0.7	NM	40.8
China Shipping Development Co.	1138.HK	Transportation	Hold	11.66	5,119	1.92	21.5	12.0	1.6	1.4	-70.0	79.5
China Telecom	0728.HK	Telecommunication Services	Hold	3.24	33,812	0.88	16.6	14.4	1.0	1.0	-30.7	15.4
China Vanke - A shares	000002.SZ	Real Estate	Hold	10.81	17,414	0.99	21.1	17.7	3.2	2.8	14.3	19.5
CNOOC Ltd	0883.HK	Energy	Hold	12.20	70,198	1.41	15.4	14.0	2.7	2.4	-29.7	9.9
COLI	0688.HK	Real Estate	Hold	16.40	17,030	1.01	20.6	17.2	3.3	2.8	55.6	20.3
Cosco Pacific	1199.HK	Transportation	Hold	9.93	2,897	1.79	16.3	12.7	1.1	1.0	-34.0	28.6
Country Garden Holdings	2007.HK	Real Estate	Hold	2.89	6,078	0.94	15.5	14.8	1.8	1.6	2.4	4.3
Denway Motors	0203.HK	Automobiles & Components	Hold	4.94	4,789	1.01	14.1	12.1	2.3	2.0	10.7	16.6
Dongfang Electric	1072.HK	Capital Goods	Hold	41.60	4,731	1.12	18.8	15.8	8.6	6.2	257.6	18.8
Geely Auto	0175.HK	Automobiles & Components	Hold	4.27	3,826	0.98	25.2	18.5	4.5	3.6	45.8	36.2
Greentown China	3900.HK	Real Estate	Hold	12.16	2,313	1.39	21.0	19.3	1.7	1.6	4.7	8.7
Guangshen Railway	0525.HK	Transportation	Hold	3.17	2,895	1.03	15.6	15.8	0.9	0.9	3.7	-1.5
Guangzhou R&F Prop	2777.HK	Real Estate	Hold	13.70	5,692	1.75	15.3	13.9	2.4	2.1	25.1	10.5
Huaneng Power Intl	0902.HK	Utilities	Hold	4.39	6,824	0.85	8.9	13.8	1.1	1.1	NM	-35.6
Industrial Bank	601166.SS	Banks	Hold	40.31	29,530	1.22	16.0	13.8	3.5	3.0	10.6	15.8
Jiangsu Expressway-H	0177.HK	Transportation	Hold	6.92	4,495	0.79	15.7	14.1	2.1	2.0	23.0	11.1
Jiangxi Copper	0358.HK	Materials	Hold	18.36	7,156	1.65	15.3	10.9	2.2	2.0	51.7	40.2
Lenovo Group Ltd	0992.HK	Technology Hardware & Equ	Hold	4.86	5,560	1.12	-18.7	51.7	1.6	4.2	NM	NM
Li Ning Co Ltd	2331.HK	Consumer Durables & Appar	Hold	29.50	3,940	0.94	29.4	24.3	11.8	9.9	28.6	21.1
Little Sheep Group Limited	0968.HK	Consumer Services	Hold	4.30	566	NA	26.0	21.8	4.0	3.6	7.0	19.4
Netease.com	NTES.OQ	Software & Services	Hold	37.01	4,762	0.95	17.4	13.7	4.4	3.3	17.6	27.1
Parkson Retail Group	3368.HK	Retailing	Hold	13.68	4,935	1.01	35.0	27.8	8.6	7.4	14.5	26.2
PetroChina	0857.HK	Energy	Hold	9.32	219,946	1.29	13.7	12.4	1.8	1.6	-4.6	10.7
Renesola	SOL.N	Semiconductors & Semicond	Hold	4.82	492	NA	-11.3	12.4	1.3	1.2	45.8	NM
RREEF China Comm Trust	0625.HK	Real Estate	Hold	3.24	194	0.49	12.9	17.9	0.6	0.6	16.1	-28.2
Shanghai Electric	2727.HK	Capital Goods	Hold	3.59	5,790	1.28	15.5	13.8	1.7	1.5	0.4	12.5
Shanghai Pudong Bank	600000.SS	Banks	Hold	21.69	22,715	1.28	12.0	11.6	2.8	2.4	-27.7	4.1
Shenzhen Dev Bank	000001.SZ	Banks	Hold	24.37	11,941	0.92	16.0	16.7	2.8	2.4	588.0	-4.0
Shenzhen Expressway-H	0548.HK	Transportation	Hold	3.82	1,074	0.91	14.7	13.1	1.0	1.0	-1.0	12.0
Shui On Land Ltd	0272.HK	Real Estate	Hold	4.60	2,482	1.49	11.2	10.8	0.9	0.9	-38.5	3.6
Sinotruk (Hong Kong)	3808.HK	Capital Goods	Hold	9.07	2,539	0.73	19.8	17.4	1.4	1.3	4.1	14.0
Sohu.com Inc	SOHU.OQ	Software & Services	Hold	57.51	2,206	1.44	14.8	12.9	4.3	3.3	-3.8	14.3
Tianjin Capital	1065.HK	Commercial Services & Supp	Hold	2.77	510	1.08	14.2	19.8	1.1	1.0	8.2	-28.2
Tingyi	0322.HK	Food, Beverage & Tobacco	Hold	19.20	13,831	0.47	35.7	28.7	10.9	9.1	49.6	24.2
Towngas China	1083.HK	Utilities	Hold	3.13	790	0.55	25.0	20.8	1.0	0.9	22.5	20.4
Trina Solar	TSL.N	Capital Goods	Hold	53.62	1,436	2.25	20.5	19.8	2.6	2.1	6.9	3.6
Tsingtao Brewery Co Ltd-H	0168.HK	Food, Beverage & Tobacco	Hold	43.00	7,301	0.69	38.3	34.1	7.0	6.5	85.0	12.1
XinAo Gas	2688.HK	Utilities	Hold	20.00	2,604	0.74	21.5	19.6	3.7	3.2	52.0	10.0
Yingli Green Energy	YGE.N	Capital Goods	Hold	15.88	2,202	NA	-57.7	26.1	2.3	2.3	NM	NM
Zhong An Real Estate Ltd	0672.HK	Real Estate	Hold	2.91	750	0.81	14.3	11.4	1.2	1.1	98.3	26.0
ZTE Corp-H	0763.HK	Technology Hardware & Equ	Hold	48.00	10,809	1.05	31.4	24.7	4.5	4.0	45.6	26.9
Agile Property	3383.HK	Real Estate	Sell	11.40	5,506	1.81	17.2	14.3	2.6	2.3	64.9	20.3
BYD	1211.HK	Capital Goods	Sell	68.45	18,922	0.78	40.1	31.9	8.5	6.7	201.8	25.5
China Cosco Hldgs	1919.HK	Transportation	Sell	9.55	12,580	2.03	-15.1	222.1	1.8	1.8	NM	NM
CHINA EASTERN AIRLINES	0670.HK	Transportation	Sell	2.77	2,361	1.09	-3.7	63.8	71.7	9.9	60.1	NM
China Resources Land	1109.HK	Real Estate	Sell	17.64	11,408	0.99	31.2	28.1	2.4	2.2	30.4	11.0
China Shipping Container	2866.HK	Transportation	Sell	2.80	4,218	1.77	-4.2	-11.5	1.2	1.3	NM	63.2
China Southern Airlines	1055.HK	Transportation	Sell	2.42	2,310	1.11	-34.1	13.3	1.6	1.4	92.8	NM
China Unicom	0762.HK	Telecommunication Services	Sell	10.28	31,483	0.56	20.3	27.3	1.0	1.0	-26.1	-25.7
CNPC-HK	0135.HK	Energy	Sell	10.32	6,337	0.77	45.2	34.3	4.3	3.9	-66.9	31.8
Datang Int'l Power	0991.HK	Utilities	Sell	3.35	5,075	1.34	26.7	31.2	1.3	1.3	NM	-14.6
Harbin Power Equipment	1133.HK	Capital Goods	Sell	6.94	1,232	1.40	14.8	10.4	1.0	0.9	-45.5	42.5
Huadian Power	1071.HK	Utilities	Sell	2.06	1,599	1.00	9.8	20.7	0.9	0.9	NM	-52.6
Shanda	SNDA.OQ	Software & Services	Sell	52.10	3,492	0.79	16.0	16.8	2.3	2.1	29.0	-4.9
Suntech Power Holdings	STP.N	Capital Goods	Sell	16.47	2,792	2.39	61.7	25.6	1.8	1.7	-56.1	141.5
Yangzijiang Shipbldg	YAZG.SI	Capital Goods	Sell	1.21	3,146	1.25	10.1	9.4	3.5	2.7	28.9	7.9

Source: Deutsche Bank Note: details of coverage, ratings and target prices may be found on http://gm.db.com

Appendix 1

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Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.
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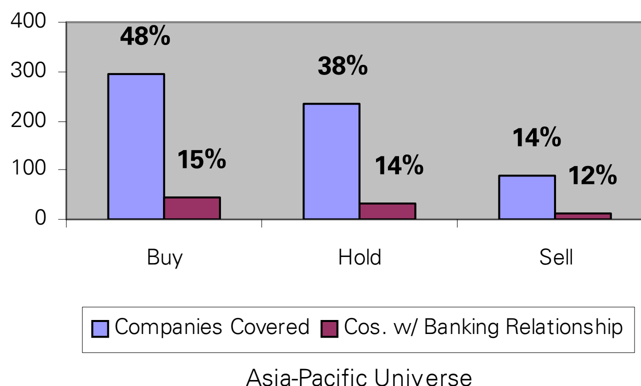
Notes:
1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:
Buy: Expected total return (including dividends) of 10% or more over a 12-month period
Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Asia-Pacific Universe

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